



Management's Discussion and Analysis of Financial Conditions and Results of Operations

Summary

In 2010, the Group actively expanded its full services operation to promote the strategy of “Customer-focused Innovative Informatisation”, implementing differentiated development and operating strategy. This resulted in revenue and profit growth in tandem, noticeable improvement of profitability and preliminary accomplishment of effective scale development. The Group's operating revenues in 2010 were RMB219,864 million, an increase of 5.0% from 2009; operating expenses were RMB195,848 million, an increase of 4.9% from 2009; profit attributable to equity holders of the Company was RMB15,759 million and basic earnings per share was RMB0.19; EBITDA¹ was RMB88,992 million and the EBITDA margin was 40.5%.

Excluding the amortisation of upfront connection fees, the operating revenues of the Group in 2010 were RMB219,367 million, an increase of 5.4% from 2009; profit attributable to equity holders of the Company was RMB15,262 million, an increase of 15.0% from 2009, basic earnings per share was RMB0.19; EBITDA was RMB88,495 million and the EBITDA margin was 40.3%.

Operating Revenues

In 2010, facing the challenges from frequent natural disasters, intense market competition and continuous decline in the wireline services, the Group continued to deepen its strategic transformation and implemented the strategy of integrated and differentiated development in full swing. Our full services operation has achieved remarkable development with steady growth of operating revenues. Operating revenues in 2010 were RMB219,864 million, an increase of 5.0% from 2009. Excluding the amortisation of upfront connection fees of RMB497 million, operating revenues in 2010 were RMB219,367 million, an increase of 5.4% from 2009. Of this, the total mobile revenue was RMB53,953 million, an increase of 51.5% from 2009. Excluding the amortisation of upfront connection fees, the wireline service revenue was RMB165,414 million, a decrease of 4.2% from 2009. The ratio of wireline non-voice services to total revenue from wireline services, excluding the amortisation of upfront connection fees, has increased over the year to 62.2% in 2010, a rise of 7.6 percentage points from 2009. The Group has consistently optimised its revenue structure and innovated its development model with improvement in risk resistance capability.

The following table sets forth a breakdown of the operating revenues of the Group for 2009 and 2010, together with their respective rates of change:

	For the year ended 31 December		
(RMB in millions, except percentage data)	2010	2009	Rate of Change
Wireline voice	62,498	78,432	(20.3%)
Mobile voice	28,906	20,027	44.3%
Internet	63,985	51,567	24.1%
Value-added services	22,571	21,533	4.8%
Integrated information application services	15,519	12,659	22.6%
Managed data and leased line	12,389	11,499	7.7%
Others	13,499	12,502	8.0%
Upfront connection fees	497	1,151	(56.8%)
Total operating revenues	219,864	209,370	5.0%

¹ EBITDA was calculated from operating revenues minus operating expenses (which excluded depreciation and amortisation and CDMA network capacity lease fee). As the telecommunications business is a capital intensive industry, capital expenditure, the level of gearing and finance costs may have a significant impact on the net profit of companies with similar operating results. Therefore, we believe EBITDA may be helpful in analysing the operating results of a telecommunications service provider such as the Company. Although EBITDA has been widely applied in the global telecommunications industry as a benchmark to reflect operating performance, financial capability and liquidity, it is not regarded as a measure of operating performance and liquidity under generally accepted accounting principles. It also does not represent net cash from operating activities. In addition, our EBITDA may not be comparable to similar indicators provided by other companies.



Management's Discussion and Analysis of Financial Conditions and Results of Operations

Wireline Voice

Although the Group has adopted the integrated operations model to minimise the declining trend of traditional wireline services, revenue from wireline voice continued to decrease due to the increased cannibalisation of wireline voice usage by other forms of communication, such as mobile communications and VOIP, as well as the decline in PAS services. In 2010, revenue from wireline voice services was RMB62,498 million, a decrease of 20.3% from RMB78,432 million in 2009, accounting for 28.4% of our operating revenues.

Mobile Voice

In 2010, revenue from mobile voice services was RMB28,906 million, an increase of 44.3% from RMB20,027 million in 2009, accounting for 13.1% of our operating revenues. With more than two years full services operation, the Group has successfully entered the mobile market, and the mobile services grew rapidly. At the end of 2010, the number of mobile subscribers reached 90.52 million, an increase of 61.4% from the beginning of the year.

Internet

In 2010, revenue from Internet access services was RMB63,985 million, an increase of 24.1% from RMB51,567 million in 2009, accounting for 29.1% of our operating revenues. Through network speed upgrade and integrated operations, the number of broadband subscribers has increased continuously and hence, revenue from our Internet access services has grown rapidly. At the end of 2010, the number of wireline broadband subscribers increased by 18.7% to 63.48 million, a net increase of 10.02 million subscribers from the end of 2009. Revenue from mobile Internet access services was RMB9,020 million, an increase of 139.9% from 2009.

Value-Added Services

In 2010, revenue from value-added services was RMB22,571 million, an increase of 4.8% from RMB21,533 million in 2009, accounting for 10.3% of our operating revenues. The increase in revenue was mainly attributable to the rapid growth of mobile value-added services. Revenue from mobile value-added services was RMB7,858 million, an increase of 40.3% from 2009. Due to the decline in PAS services, revenue from wireline value-added services as a whole decreased.

Integrated Information Application Services

In 2010, revenue from integrated information application services was RMB15,519 million, an increase of 22.6% from RMB12,659 million in 2009, accounting for 7.1% of our operating revenues. The increase in revenue was mainly due to the rapid development of the IT service and applications services as well as "Best Tone" type of information services. Revenue from mobile integrated information application services was RMB1,920 million, an increase of 216.3% from 2009.

Managed Data and Leased Line

In 2010, revenue from managed data and leased line services was RMB12,389 million, an increase of 7.7% from RMB11,499 million in 2009, accounting for 5.6% of our operating revenues. The increase in revenue was mainly attributable to the increasing demand from customers for network resources and informatisation which resulted in increased revenue growth from the leased circuits services, IP-VPN services, leased equipment for system integration and Mega-Eye services. Revenue from mobile managed data and leased line services was RMB18 million.

Management's Discussion and Analysis of Financial Conditions and Results of Operations

Others

In 2010, revenue from other services was RMB13,499 million, an increase of 8.0% from RMB12,502 million in 2009, accounting for 6.1% of our operating revenues. The growth of revenue was mainly attributable to the sales revenue of mobile terminal equipment and system integration equipment. Revenue from other mobile services was RMB6,231 million, an increase of 10.9% from 2009.

Upfront Connection Fees

Upfront connection fees represent the amortised amount of upfront fees received for the initial activation of wireline services of the Group, which were amortised over an expected customer relationship period of 10 years. Effective from July 2001, the Group ceased to charge new subscribers upfront connection fees. The amortised amount was RMB497 million in 2010, representing a decrease of 56.8% from RMB1,151 million in 2009.

The amortisation of upfront connection fees will end in July 2011. The amortised upfront connection fees for the year 2011 will be RMB98 million.

Operating Expenses

In 2010, the operating expenses of the Group were RMB195,848 million, an increase of 4.9% from 2009. The ratio of operating expenses to operating revenues fell to 89.1% in 2010, a slight decrease as compared to that of 2009. Through positive cost strategy and centralised resources deployment, more costs were tilted towards key customers and high-value services and the Group has stringent control over resources allocation to low-end customers and the projects with low rate of return on investment, which has effectively boosted the full services operation.

The following table sets forth a breakdown of the operating expenses of the Group in 2009 and 2010 and their respective rates of change:

	For the year ended 31 December		
<i>(RMB in millions, except percentage data)</i>	2010	2009	Rates of Change
Depreciation and amortisation	51,656	52,243	(1.1%)
Network operations and support expenses	47,288	42,903	10.2%
Selling, general and administrative expenses	42,130	40,507	4.0%
Personnel expenses	35,529	32,857	8.1%
Other operating expenses	19,106	17,449	9.5%
Impairment loss on property, plant and equipment	139	753	(81.5%)
Total operating expenses	195,848	186,712	4.9%

Depreciation and Amortisation

In 2010, depreciation and amortisation was RMB51,656 million, a decrease of 1.1% from RMB52,243 million in 2009, accounting for 23.6% of our operating revenues. The decline was due to the continuous stringent control of capital expenditure by the Group.



Management's Discussion and Analysis of Financial Conditions and Results of Operations

Network Operations and Support Expenses

In 2010, network operations and support expenses were RMB47,288 million, an increase of 10.2% from RMB42,903 million in 2009, accounting for 21.5% of our operating revenues. The increase was mainly attributable to the increase in CDMA network capacity lease fee and the costs for transformation services by the Group. The CDMA network capacity lease fee in 2010 amounted to RMB13,320 million, an increase of 58.9% from 2009.

Selling, General and Administrative Expenses

In 2010, selling, general and administrative expenses amounted to RMB42,130 million, an increase of 4.0% from RMB40,507 million in 2009, accounting for 19.2% of our operating revenues. The growth was mainly attributable to the appropriate increase in the expenses for market expansion and distribution channels. In the meantime, the Group has stringent cost control measures on administrative expenses and non-production expenditure, reducing the general and administrative expenses by 8.0% from 2009.

Personnel Expenses

In 2010, personnel expenses were RMB35,529 million, an increase of 8.1% from RMB32,857 million in 2009, accounting for 16.2% of our operating revenues. The increase in personnel expenses was mainly due to increased efforts in attracting and motivating talents as well as enhancing performance-based incentive schemes of the frontline employees.

Other Operating Expenses

In 2010, other operating expenses were RMB19,106 million, an increase of 9.5% from RMB17,449 million in 2009, accounting for 8.7% of our operating revenues. The increase was largely attributed to the growth in the mobile interconnection expenses. The mobile interconnection expenses amounted to RMB5,821 million in 2010, an increase of 67.9% from 2009.

Net Finance Costs

In 2010, the Group's net finance costs were RMB3,600 million, a decline of 17.7% from RMB4,375 million in 2009. Net interest expenses fell by RMB929 million. The decrease was mainly attributable to the Group's increased repayment of the bank loans and other loans. Net exchange losses were RMB92 million in 2010, while net exchange gains were RMB67 million in 2009. The change in net exchange loss/gain was mainly attributable to the depreciation of the RMB against the Japanese Yen.

Profitability Level

Income Tax

The Group's statutory income tax rate is 25%. In 2010, the Group's income tax expenses were RMB5,031 million with the effective income tax rate of 24.1%. The difference between the effective income tax rate and the statutory income tax rate of the Group was mainly attributable to the exclusion of upfront connection fees from taxable revenue, and the preferential income tax rate of 22% or 15% enjoyed by our branches located in special economic zones and the western regions of China.

Management's Discussion and Analysis of Financial Conditions and Results of Operations

Profit Attributable To Equity Holders of the Company

In 2010, profit attributable to equity holders of the Company was RMB15,759 million, an increase of 9.3% from RMB14,422 million in 2009. Excluding the amortisation of upfront connection fees, the profit attributable to equity holders of the Company was RMB15,262 million, an increase of 15.0% from RMB13,271 million in 2009.

Capital Expenditure and Cash Flows

Capital Expenditure

In 2010, the Group accelerated the development of broadband services and increased investment in optic fiber upgrade and broadband access capabilities. In the meantime, the Group continued to manage and control its capital expenditure, strictly control the investment in traditional wireline voice services. Capital expenditure was RMB43,037 million, an increase of 13.1% from RMB38,042 million in 2009.

Cash Flows

In 2010, net decrease in cash and cash equivalents for the Group was RMB8,934 million, while the net increase in cash and cash equivalents was RMB6,940 million in 2009.

The following table sets forth the cash flow position of the Group in 2009 and 2010:

(RMB millions)	For the year ended 31 December	
	2010	2009
Net cash flow from operating activities	75,571	74,988
Net cash used in investing activities	(45,734)	(43,255)
Net cash used in financing activities	(38,771)	(24,793)
Net (decrease)/increase in cash and cash equivalents	(8,934)	6,940

In 2010, the net cash inflow from operating activities was RMB75,571 million, an increase of RMB583 million from RMB74,988 million in 2009.

In 2010, the net cash outflow for investing activities was RMB45,734 million, an increase of RMB2,479 million from RMB43,255 million in 2009, mainly resulting from an increase in the Group's capital expenditure in 2010.

In 2010, the net cash outflow for financing activities was RMB38,771 million, an increase of RMB13,978 million from RMB24,793 million in 2009. The increase in net cash outflow was mainly due to the Group's increased repayment of the bank loans and other loans.

Working Capital

At the end of 2010, the Group's working capital (total current assets minus total current liabilities) deficit was RMB71,678 million, a reduction of deficit of RMB10,867 million from RMB82,545 million in 2009. The decrease in deficit was mainly attributable to the increased operating revenues of RMB10,494 million. As at 31 December 2010, the Group's unutilised committed credit facilities was RMB98,576 million (2009: RMB102,555 million). At the end of 2010, the Group's cash and cash equivalents amounted to RMB25,824 million, amongst which cash and cash equivalents denominated in Renminbi accounted for 91.2% (2009: 94.7%).



Management's Discussion and Analysis of Financial Conditions and Results of Operations

Assets and Liabilities

In 2010, the Group continued to maintain a solid capital structure. By the end of 2010, the total assets of the Group fell to RMB407,355 million from RMB426,520 million at the end of 2009, while total indebtedness decreased to RMB73,576 million from RMB105,923 million in 2009. The ratio of the Group's total indebtedness to total assets fell from 24.8% at the end of 2009 to 18.1% at the end of 2010.

Indebtedness

The indebtedness analysis of the Group as of the end of 2009 and 2010 is as follows:

(RMB millions)	For the year ended 31 December	
	2010	2009
Short-term debt	20,675	51,650
Long-term debt maturing within one year	10,352	1,487
Finance lease obligations maturing within one year	–	18
Long-term debt (excluding current portion)	42,549	52,768
Total debt	73,576	105,923

By the end of 2010, the total indebtedness of the Group was RMB73,576 million, a decrease of RMB32,347 million from 2009. The main reason for the decrease was the Group's repayment of a portion of bank loans and other loans. Of the total indebtedness of the Group, the Company's loans in Renminbi, US Dollars, Japanese Yen and Euro accounted for 96.0% (2009: 96.9%), 1.0% (2009: 0.8%), 2.2% (2009: 1.7%), and 0.8% (2009: 0.6%) respectively. 98.5% (2009: 95.7%) of this indebtedness are loans with fixed interest rates, while the remainder are loans with floating interest rates.

As of 31 December 2010, the Group did not pledge any assets as collateral for debt (2009: Nil).

Most of the Group's revenue receipts from and payments made for its business were denominated in Renminbi, therefore the Group did not have significant risk exposure to foreign exchange fluctuations.

Contractual Obligations

(RMB millions)	Total	Payable in				
		1 January 2011 – 31 December 2011	1 January 2012 – 31 December 2012	1 January 2013 – 31 December 2013	1 January 2014 – 31 December 2014	Thereafter
Short-term debt	20,924	20,924	–	–	–	–
Long-term debt	59,560	12,802	13,261	11,435	21,022	1,040
Operating lease commitments	27,180	13,525	11,531	577	439	1,108
Capital commitments	5,124	5,124	–	–	–	–
Total contractual obligations	112,788	52,375	24,792	12,012	21,461	2,148

Note: Amounts of short-term debt and long-term debt include recognised and unrecognised interest payable, and are not discounted.



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people to empower them to
tackle new challenges**