

# Management's Discussion and Analysis

## Financial Review

### Summary

In 2016, with reform and innovation as the driving force, the Company adhered to the "2+5" operation focuses, changed the mode of development, strengthened the six key capabilities in order to enhance the effectiveness of operational management. The overall operating results were steadily improved. Operating revenues in 2016 were RMB352,285 million, an increase of 6.4% from 2015; service revenues<sup>1</sup> were RMB309,644 million, an increase of 5.6% from 2015; operating expenses were RMB325,084 million, an increase of 6.7% from 2015; profit attributable to equity holders of the Company was RMB18,004 million, a decrease of 10.2% from 2015; basic earnings per share were RMB0.22; EBITDA<sup>2</sup> was RMB95,139 million, an increase of 1.1% from 2015 and the EBITDA margin<sup>3</sup> was 30.7%.

### Operating Revenues

In 2016, while proactively responding to the impact of regulatory policies such as Speed Upgrade and Tariff Reduction, implementation of real-name registration and regional integration as a whole, the Company accelerated the scale development of 4G and fibre broadband business, continued to optimise its business structure and achieved a stable growth in its operating revenues. Operating revenues in 2016 were RMB352,285 million, an increase of 6.4% from 2015. Of which, the total mobile revenues were RMB172,223 million, an increase of 10.0% from 2015; the total wireline revenues were RMB180,062 million, an increase of 3.1% from 2015.

<sup>1</sup> Service revenues were calculated based on operating revenues minus sales of mobile terminals (2016: RMB34,612 million; 2015: RMB32,026 million), sales of wireline equipment (2016: RMB5,822 million; 2015: RMB4,430 million) and other non-service revenues (2016: RMB2,207 million; 2015: RMB1,480 million).

<sup>2</sup> EBITDA was calculated based on operating revenues minus operating expenses plus depreciation and amortisation. 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, debt raising ability 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.

<sup>3</sup> EBITDA margin was calculated based on EBITDA divided by service revenues.

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The following table sets forth a breakdown of the operating revenues for 2015 and 2016, together with their respective rates of change:

<i>(RMB millions, except percentage data)</i>	<b>For the year ended 31 December</b>		
	<b>2016</b>	2015	Rates of change
Voice	<b>70,120</b>	78,593	(10.8%)
Internet	<b>150,405</b>	126,546	18.9%
Information and application services	<b>66,838</b>	66,343	0.7%
Telecommunications network resource services and lease of network equipment	<b>17,773</b>	17,635	0.8%
Others	<b>47,149</b>	42,085	12.0%
<b>Total operating revenues</b>	<b>352,285</b>	331,202	6.4%

### Voice

In 2016, being affected by the substitution effect of mobile Internet services, such as OTT, revenue from voice services was RMB70,120 million, a decrease of 10.8% from 2015, accounting for 19.9% of operating revenues. Of this, revenue from wireline voice services was RMB25,987 million, a decrease of 12.2% from 2015, revenue from mobile voice services was RMB44,133 million, a decrease of 9.9% from 2015. The revenue contribution from voice services continued to decrease, resulting in persistent improvement in structures and effective mitigation of operating risks.

### Internet

In 2016, revenue from Internet services was RMB150,405 million, an increase of 18.9% from 2015, accounting for 42.7% of operating revenues. The Company comprehensively upgraded the broadband access network, leveraged the integration advantage of "4G + fibre broadband + e-Surfing HD" and promoted the healthy development of broadband services. At the end of 2016, the number of wireline broadband subscribers reached 123 million, with a net increase of 10.06 million. The wireline broadband revenue was RMB76,766 million, an increase of 3.3% from 2015. The Company deepened the data traffic operation, enhanced integration of contents and data traffic and effectively drove the acceleration of mobile data traffic and revenue growth. Revenue from mobile Internet access services was RMB70,682 million, an increase of 39.4% from 2015. Of this, mobile handset Internet access revenue was RMB68,263 million, an increase of 42.9% from 2015.

### Information and Application Services

In 2016, revenue from information and application services was RMB66,838 million, an increase of 0.7% from 2015, accounting for 19.0% of operating revenues. Of which, revenue from wireline information and application services was RMB44,335 million, an increase of 5.5% from 2015, mainly benefiting from the rapid growth of IDC, cloud and e-Surfing HD services. Revenue from mobile information and application services was RMB22,503 million, a decrease of 7.4% from 2015, which was mainly due to the decrease in revenue from traditional services such as short and multimedia messaging services and information inquiry services.

### Telecommunications Network Resource Services and Lease of Network Equipment

In 2016, revenue from telecommunications network resource services and lease of network equipment was RMB17,773 million, an increase of 0.8% from 2015, accounting for 5.0% of operating revenues. Of which, revenue from wireline telecommunications network resource services and lease of network equipment was RMB17,595 million, an increase of 2.2% from 2015.

### Others

In 2016, revenue from other services was RMB47,149 million, an increase of 12.0% from 2015, accounting for 13.4% of operating revenues. Revenue from sales of mobile terminals was RMB34,612 million, an increase of 8.1% from 2015, which was mainly due to the growth in sales of mobile terminals driven by the sales of "multi-mode" handsets.

## Service Revenues



## Operating Expenses

The Company continued to optimise the allocation of resources and strengthened the precision management of costs and expenses in order to effectively support the business development. In 2016, the operating expenses were RMB325,084 million, an increase of 6.7% from 2015. Operating expenses accounted for 92.3% of operating revenues, an increase of 0.3 percentage point from 2015.

The following table sets forth a breakdown of the operating expenses in 2015 and 2016 and their respective rates of change:

<i>(RMB millions, except percentage data)</i>	<b>For the year ended 31 December</b>		
	<b>2016</b>	2015	Rates of change
Depreciation and amortisation	<b>67,938</b>	67,664	0.4%
Network operations and support	<b>94,092</b>	81,240	15.8%
Selling, general and administrative	<b>56,417</b>	54,472	3.6%
Personnel expenses	<b>54,460</b>	52,541	3.7%
Other operating expenses	<b>52,177</b>	48,843	6.8%
Total operating expenses	<b>325,084</b>	304,760	6.7%

### Depreciation and Amortisation

In 2016, depreciation and amortisation was RMB67,938 million, an increase of 0.4% from 2015, accounting for 19.3% of operating revenues. The depreciation and amortisation of the newly added assets in 2016 was basically equivalent to the decrease in depreciation and amortisation resulted from the disposal of tower assets.

### Network Operations and Support

In 2016, network operations and support expenses were RMB94,092 million, an increase of 15.8% from 2015, accounting for 26.7% of operating revenues. The growth was mainly due to the increase in the tower assets lease fee and related expenses. At the same time, the Company continuously strengthened cost management and control and the growth rate of network operations and support expenses was lower than that in the same period of last year.

### Selling, General and Administrative

In 2016, selling, general and administrative expenses amounted to RMB56,417 million, an increase of 3.6% from 2015, accounting for 16.0% of operating revenues. Selling expenses were RMB47,821 million, an increase of 4.1% from 2015. The increase was due to the fact that the Company appropriately increased initiatives in marketing resources while continued to enhance the efficiency of resources utilisation. Of which, commission and service expenses for third parties amounted to RMB30,753 million, an increase of 15.4% from 2015. Advertising and promotion expenses amounted to RMB17,068 million, a decrease of 11.5% from 2015, of which the terminal subsidies amounted to RMB9,370 million, a decrease of 19.4% from 2015.

### Personnel Expenses

In 2016, personnel expenses were RMB54,460 million, an increase of 3.7% from 2015, accounting for 15.5% of operating revenues. For details of the number of employees, remuneration policies and training schemes, please refer to the Environmental, Social and Governance Report in this annual report.

### Other Operating Expenses

In 2016, other operating expenses were RMB52,177 million, an increase of 6.8% from 2015, accounting for 14.8% of operating revenues. The cost of mobile terminal equipment sold amounted to RMB32,849 million, an increase of 6.4% from 2015, which was mainly due to the increase in terminal sales leading to an increase in expenses.

### Net Finance Costs

In 2016, net finance costs were RMB3,235 million, a decrease of 24.3% from 2015. The decrease was mainly due to the fact that the interest rate of the deferred consideration of Mobile Network Acquisition decreased from 5.11% per annum in 2015 to 4.00% per annum in 2016 (adjusted in accordance with a 5 basis points premium to the yield of the 5-year super AAA rated Medium Term Notes once a year pursuant to the agreement). Net exchange gains were RMB113 million in 2016. The fluctuation of foreign exchange gain or loss was mainly due to the depreciation of the RMB exchange rate against the US Dollar.

Net  
Finance Costs 

 24.3% 

### Profitability Level

#### Income Tax

The Company's statutory income tax rate is 25%. In 2016, income tax expenses were RMB5,988 million with the effective tax rate of 24.8%. The difference between the effective income tax rate and the statutory income tax rate was mainly due to the preferential income tax rate, which was lower than the statutory income tax rate, enjoyed by some of our branches with operations in the western region of China and some of our subsidiaries.

#### Profit Attributable to Equity Holders of the Company

In 2016, profit attributable to equity holders of the Company was RMB18,004 million, a decrease of 10.2% from 2015.



## Capital Expenditure and Cash Flows

### Capital Expenditure

In 2016, the Company strictly controlled the total amount of capital expenditure. On the basis of steady promotion of 4G and fibre broadband network investment, the Company continuously optimised the investment structure to ensure the maximisation of investment efficiency. In 2016, capital expenditure was RMB96,817 million, a decrease of 11.3% from 2015.

### Cash Flows

In 2016, net decrease in cash and cash equivalents was RMB7,463 million, while the net increase in cash and cash equivalents was RMB11,309 million in 2015.

The following table sets forth the cash flow position in 2015 and 2016:

<i>(RMB millions)</i>	<b>For the year ended</b>	
	<b>31 December</b>	
	<b>2016</b>	2015
Net cash flow from operating activities	<b>101,130</b>	108,750
Net cash used in investing activities	<b>(99,038)</b>	(102,250)
Net cash (used in)/from financing activities	<b>(9,555)</b>	4,809
Net (decrease)/increase in cash and cash equivalents	<b>(7,463)</b>	11,309

In 2016, the net cash inflow from operating activities was RMB101,130 million, a decrease of 7.0% from 2015, which was mainly due to the increase in costs and expenses related to operating activities.

In 2016, the net cash outflow used in investing activities was RMB99,038 million, a decrease of 3.1% from 2015, which was mainly due to the decrease of capital expenditure for the year.

In 2016, the net cash outflow used in financing activities was RMB9,555 million, and the net cash inflow from financing activities in 2015 was RMB4,809 million. The change was mainly due to the repayment of part of the short-term commercial papers in 2016.

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#### Working Capital

The Company consistently upheld prudent financial principles and strict fund management policies. At the end of 2016, working capital (total current assets minus total current liabilities) deficit was RMB245,026 million, an increase in deficit of RMB67,205 million from RMB177,821 million in 2015. The deficit increased because the deferred consideration of RMB61,710 million for the Mobile Network Acquisition will become due at the end of 2017 and was reclassified as current liabilities. As at 31 December 2016, the unutilised credit facilities were RMB161,229 million (2015: RMB128,839 million). Given the stable net cash inflow from operating activities and the sound credit record, the Company has sufficient working capital to

satisfy the operation requirement. At the end of 2016, cash and cash equivalents amounted to RMB24,617 million, amongst which cash and cash equivalents denominated in Renminbi accounted for 81.8% (2015: 92.6%).

#### Assets and Liabilities

In 2016, the Company continued to maintain a solid financial position. At the end of 2016, the total assets increased by 3.6% to RMB652,368 million from RMB629,561 million at the end of 2015. Total indebtedness decreased to RMB112,528 million from RMB116,669 million at the end of 2015. The ratio of total indebtedness to total assets decreased to 17.2% from 18.5% at the end of 2015.

#### Indebtedness

The indebtedness analysis as at the end of 2015 and 2016 is as follows:

(RMB millions)	For the year ended	
	31 December	2015
	2016	
Short-term debt	<b>40,780</b>	51,636
Long-term debt and payable maturing within one year	<b>62,276</b>	84
Long-term debt and payable	<b>9,370</b>	64,830
Finance lease obligations (including current portion)	<b>102</b>	119
Total debt	<b>112,528</b>	116,669

By the end of 2016, the total indebtedness was RMB112,528 million, a decrease of RMB4,141 million from the end of 2015, which was mainly due to the repayment of part of the short-term commercial papers. Of the total indebtedness, loans denominated in Renminbi, US Dollars and Euro accounted for 99.4% (2015: 99.4%), 0.4% (2015: 0.4%) and 0.2% (2015: 0.2%), respectively. 44.3% (2015: 46.3%) of the indebtedness are loans with fixed interest rates, while the remaining portion of the indebtedness represented loans with floating interest rates.

As at 31 December 2016, neither the Company and any of its subsidiaries pledge any assets as collateral for debt (2015: Nil).

Most of the revenues received and expenses paid in our business were denominated in Renminbi, therefore there were no significant risk exposures arising from foreign exchange fluctuations.

## Investment in China Tower

In 2016, the Company held 27.9% of China Tower Corporation Limited ("China Tower"). Please refer to note 9 of the audited consolidated financial statements for its financial performance during the year. In the future, the Company can enjoy more fundamental network resources through China Tower. As one of the shareholders of China Tower, it is expected that we can benefit from the enhancement of profits and values from China Tower.

## Contractual Obligations

(RMB millions)	Total	1 January	Thereafter				
		2017 to 31 December	2018 to 31 December	2019 to 31 December	2020 to 31 December	2021 to 31 December	
Short-term debt	41,425	41,425	-	-	-	-	-
Long-term debt and payable	75,126	62,307	1,187	1,201	1,205	1,195	8,031
Operating lease commitments	60,981	15,492	14,351	13,704	13,256	1,112	3,066
Capital commitments	13,740	13,740	-	-	-	-	-
Total contractual obligations	191,272	132,964	15,538	14,905	14,461	2,307	11,097

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