

## CHAIRMAN'S STATEMENT

Dear Shareholders,

In the first half of 2004, driven by the sustained and rapid growth of the Chinese economy, the demand for telecommunications services continued to grow with a steady increase in the total volume of voice services, further expansion of Internet services and more opportunities for the development of value-added services. At the same time, competition within the telecommunications market further intensified. Voice services were the key focus of such competition as mobile substitution became more visible. While the increased market demands have provided us with new opportunities for development, the intensified competition among telecommunications operators has brought about new challenges to us.

Faced with this challenge, we adhered to our core value of "Innovation and Solid Execution", focussed on improving our operational systems and enhancing corporate management, and consistently promoted our "market-oriented, customer-centred and return-driven" business model throughout the organisation. These measures improved our market responsiveness, product development, marketing capabilities and our ability to thrive in the market place, increasing our profitability and shareholders' value. In the first half of 2004, our local wireline services subscriber base increased by 17.51 million, reaching 178 million at the end of June and our broadband subscriber base increased by 3.66 million, reaching 10.89 million at the end of June. Driven by the strength in our local voice services and broadband Internet services, we recorded a steady growth in operating revenue which reached RMB80,217 million, an increase of 8.3% over the same period in 2003. Our EBITDA was RMB43,991 million and our net profit was RMB14,708 million, of which RMB4,236 million was generated from amortisation of connection fees.

In the first half of this year, we successfully completed the acquisition of telecommunications businesses in ten provinces. To fund the acquisition, we raised net

proceeds of approximately US\$1.5 billion through a successful offering of new H shares. With the implementation of our management system, all levels of management of the newly acquired subsidiaries have been geared towards achieving their business and financial objectives. The growth rates of these companies increased and their operating and capital expenditures were effectively controlled, thus improving their profitability. In the first half of this year, our newly acquired telecommunications subsidiaries in the ten provinces generated revenue of RMB17,916 million from their operations, an increase of 10.0% from the same period last year, and realised net profit of RMB2,553 million, of which RMB818 million was generated from amortisation of connection fees. After the Acquisition, our basic earnings per share reached RMB0.19, representing an increase of 11.8% over the same period last year. We now enjoy better growth prospects.

In the first half of this year, we further improved the management of our distribution channels, implemented the revenue-and-service-accountability system and improved the efficiency of the distribution channels, whereby a client-focussed, full coverage distribution channel system was established which has helped to stabilise the usage from our existing customers and played an important role in driving revenue growth. At the same time, we made substantial adjustments to our marketing operation management model applied by head office, including strengthening the market strategy planning and unifying brand management, unifying customer service interface and reinforcing the sales planning function. In addition, a product development centre was set up to strengthen our business innovation capability.

Since our initial public offering, our financial management has been improving continuously. The key importance of financial management in various aspects of the business continued to be emphasised, overall budget control has been more stringently implemented



and cost control has been further improved. With more centralised network maintenance and higher efficiency, our network operations and support expenses have decreased. Following our philosophy of “running the enterprise in an industrious and economical way”, we have focussed effort in cutting our administrative expenses. As a result, our management and administrative expenditure continued to decrease. However, in order to ensure the continuing growth of our core business in a competitive environment, our sales expenses increased. Capital expenditure is expected to be more proportionate between the first half and second half of this year. The first half of this year recorded a total capital expenditure of RMB25,018 million, an increase of 12.4% from the same period last year.

In the first half of this year, we continued to focus our effort on centralising our network resources management and network maintenance. A centralised control and maintenance system covering various telecommunications networks was preliminarily established in all our local branch companies. We have further centralised the management of local branch companies' resources. A transmission resources management system has been established and a conduit resources management system is taking shape. These measures will help us to realise dynamic deployment and distribution of our network resources, effectively increase the efficiency of our network operations and maintenance, and improve our market responsiveness.

In the first half of this year, Business Process Re-engineering (“BPR”) has been extensively implemented throughout the Company. 212 out of our 228 local branch companies have adopted or are adopting BPR. With BPR as our platform to implement various new management measures, we were able to expand our process management over a wider area, implement process management reform at all levels of the

business. In particular, we have made substantial progress in our process-based and integrated management of distribution channels. The implementation of BPR has accelerated the establishment of a market-oriented, process-based management system, and further enhanced our local branch companies' overall marketing abilities, market responsiveness, provisioning capabilities and network management. This has in turn improved our operating efficiency and profitability.

Further progress has been made with the development of CTG-MBOSS, an information technology platform for our businesses. The management support system (“MSS”), one of the three sub-systems of CTG-MBOSS, has been successfully launched on a trial basis at Guangdong Telecom and Shanghai Telecom. Such system will be further implemented in these two subsidiaries and extended to subsidiaries in other provinces in the second half of this year. The implementation of MSS will enable us, through information sharing, to improve our operating efficiency and financial management and standardise the management of our internal control, thus effectively minimising business risks.

## BUSINESS REVIEW

In the first half of this year, our major business lines continued to grow. The subscriber base for our local telephone services expanded rapidly and the volume of our local voice services also increased substantially. The wireless local access service made an important contribution to the growth of our business. Broadband services continued to develop at high growth rates and revenue generated therefrom accounted for a higher proportion of our total operating revenue. The domestic long distance services recorded positive growth both in terms of volume and revenue.

### Local Telephone Services

As our core business, local telephone services recorded RMB40,527 million in revenue, an increase of 7.7% from the same period last year. Local telephone revenue accounted for 50.5% of our total operating revenue, which was similar to that of last year.

As at the end of June, our local telephone subscriber base increased by 17.51 million and by 10.9% from the end of last year, reaching 178 million. The growth in wireless local access subscribers and public telephone users was particularly strong with the total number of subscribers increasing by 10.91 million and 1.43 million, respectively, from the end of last year, reaching 36.47 million and 11.03 million, respectively. Their semi-annual growth rates were 42.7% and 14.8%, respectively.

By leveraging the strengths in our distribution channels and further promoting our packaged products in the first half of this year, we generated local telephone usage fees of RMB24,072 million, an increase of 7.1% from the same period last year. At the same time, the total usage of local voice service reached 210.7 billion pulses, an increase of 13.6% from the same period last year.

The steady and rapid increase in the number of wireless local access subscribers has effectively mitigated the pressure from mobile substitution. The packaging of wireless local access with residential and business wireline services has created synergies and increased the value of wireline services. We have reduced the investment cost of the wireless local access service per subscriber by approximately 10% and have increased the utilisation of the network by approximately 3%, thus maintaining a desirable level of investment return on such business.

### Internet Services

In the first half of this year, the revenue generated from Internet services reached RMB6,602 million, an increase of 51.6% from the same period last year, and accounted for 8.2% of our total operating revenue, which increased by 2.4 percentage points over the same period last year. This line of revenue has contributed substantially to our overall growth in revenue. As at the end of June, our subscriber base for the broadband access service reached 10.89 million, an increase of 3.66 million from the end of last year or a semi-annual growth rate of 50.6%, hence strengthening our leading position in the broadband market.

We have focussed our attention on capitalising the strength of our full service portfolio. We combined broadband access with other wireline services and broadband application services and launched flexible tariff packages to create and satisfy different customer demands. The marketing strength of our broadband access products has been improved as we extended our distribution channels to full coverage. At the same time, based on "ChinaVnet" platform, we strengthened the integration of broadband application resources to encourage third party providers to join efforts in expanding the spectrum of the broadband content and applications market. As at the end of June 2004, the number of registered subscribers for "ChinaVnet" reached 4.66 million and over 200 broadband content providers nationwide joined "ChinaVnet".

While the number of broadband subscribers was increasing rapidly, their ARPU value was kept at a relatively high level. Benefiting from economies of scale and centralised procurement, the investment cost per subscriber for broadband ADSL was reduced by approximately 5%, thus maintaining a relatively high investment return rate.



### Long Distance Services

In the first half of this year, our revenue generated from domestic long distance services was RMB13,145 million, an increase of 3.6% from the same period last year. The total transmission volume for our domestic long distance services reached 39.4 billion minutes, an increase of 21.4% from the same period last year. We continued to maintain our leading position in this area.

While benefiting from increasing demands in the domestic long distance services market which was stimulated by the rapid growth of the Chinese economy, we adopted a flexible and efficient marketing strategy in the face of market competition. We maximised revenue from the domestic long distance services by adopting appropriate pricing strategies. Sales efforts were tailored to customers based on our detailed customer segmentation. For instance, we increased the density of public telephone outlets and strengthened our control over and further motivated the agency channels. These measures enabled us to maintain our strong position in the rapidly growing long distance services market for mobile population.

Revenue from international, Hong Kong, Macau and Taiwan long distance services decreased by 2.3% from the same period last year to RMB1,906 million in the first half of this year. The volume of international long distance usage was 812 million minutes, approximately the same as that of last year.

### Managed Data and Leased Line Services

In the first half of this year, revenue generated from our managed data services was RMB1,524 million, a reduction of 6.4% from the same period last year, which accounted for 1.9% of our total operating revenue. Benefiting from the accelerating progress in the use of information technology by the general

public, the leasing of standard ports of DDN, FR and ATM increased by 3.3%, 35.6% and 1.3%, respectively, from the end of 2003. On the other hand, under the pressure of competition within the market, the unit prices for our managed data services decreased.

We generated RMB2,112 million from our leased line services in the first half of this year, a reduction of 19.0% from the same period last year, which accounted for 2.6% of our total operating revenue. As at the end of June 2004, the total number of 2M digital lines leased was 146,200, a reduction of 10.4% from the end of 2003. This decrease was mainly due to the reduction in demand for leased lines from other domestic telecommunications operators.

### Interconnection Services

In the first half of this year, revenue from interconnection services was RMB5,013 million, an increase of 22.4% from the same period last year. The net interconnection revenue was RMB3,240 million, an increase of 25.0% from the same period last year. Driven by the continuous expansion of our subscriber base and the overall growth in the domestic telecommunications market, the volume of inbound local calls reached 46.2 billion minutes in the first half of this year, an increase of 32.4% from the same period last year. The volume of inbound long distance calls also increased compared to the same period last year.

### Value-added Services

We continued our efforts to develop wireline value-added services in the first half of this year and substantially increased the revenue generated from them. As at the end of June 2004, our subscribers for the caller ID service reached 98.19 million, representing a penetration rate of 55.0%, an increase of nearly 4 percentage points from the end of 2003. The semi-

annual usage volume for our telephone information service reached 1,038 million minutes, an increase of 35.0% from the same period last year. Since the launch of the SMS over wireless local access service in the first half of this year, the volume of its usage has increased substantially and the service has demonstrated great potential for further development. As an important component of wireline services, value-added services continue to be one of our key focuses and an important source of our future growth.

#### OUTLOOK FOR THE SECOND HALF OF THE YEAR

In the second half of 2004, sustained, rapid, healthy and coordinated growth of the Chinese economy is expected. Accelerating adoption of information technology in the Chinese economy will continue to drive greater demands for telecommunications services. The increasing competition in the telecommunications market will become a significant factor in our operations in the second half of 2004.

We plan to fully explore the development potential of wireline services as our pillar business, conduct comprehensive network optimisation for the wireless local access network to improve our network quality and capability of developing new businesses. Furthermore, we will consistently develop our broadband access service, expand the market for broadband applications, strengthen the development of value-added services and continuously explore new areas for our services.

We will continue to strengthen the capacities of, and improve the management of, our distribution channels. We will also continue to harmonise the relationship between marketing, products development, distribution and customers, effectively improve marketing design and planning, and improve our brand management to enhance our brand value.

We intend to continue transforming our business towards a value-driven growth model. We will also continue to improve overall budget control and budget implementation accountability, optimise cost structure, enhance management of capital expenditure and achieve a more even distribution of capital and operating expenditure. Moreover, we will further implement BPR to establish a process-based management system with a long standing effect. We will strengthen our internal control system to achieve the international best practice, so as to mitigate business risks. We will also speed up the establishment of CTG-MBOSS to provide effective IT support for our marketing and sales, operational management and internal control.

With a view to improving our human resources capital, we will continue with our human resources reforms and implement a merit-based appointment system. We will expand our talented team consisting of professional business managers, technical specialists, skilful marketing and maintenance personnel and professional administrative personnel.

We will pay close attention to new developments in the regulation of the telecommunications industry. Based on our in-depth understanding of regulatory policies, we will continue to comply with all regulatory requirements and foster a favourable business environment. Based on a win-win philosophy and through the creation of a favourable competitive environment, we will promote the healthy development of the industry.

In summary, we will adhere to our goal of becoming “a world-class telecommunications operator”. Focussing on rapid development, continued business reform, effective management and human-resources-based

strategy, we will strive to achieve the sustainable and sound development of the business and maximise shareholders' value.

**Zhou Deqiang**

*Chairman and CEO*

Beijing, PRC

1 September 2004