

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS



You should read the following discussion and analysis in conjunction with our audited financial statements and the accompanying notes included elsewhere in this annual report.

Overview

We made substantial achievements in the fiscal year of 2002, in terms of steady revenue growth, effective control of operating expenses, significantly improved profitability and strong growth of cash generated from operations. We also significantly reduced our capital expenditures in 2002. As a result, we managed to achieve our internal financial targets. Our strong financial position has set a solid foundation for future developments.

Our total operating revenue in 2002 grew 10.1% over that in 2001 to RMB75,496 million. Our operating expenses increased by 7.3% to RMB54,118 million in 2002. Surpassing the profit forecast set out in our initial public offering prospectus by RMB367 million, we attained a net income of RMB16,864 million for the year and our basic earnings per share was RMB0.24. Our EBITDA⁽¹⁾ was RMB42,260 million in 2002, representing an EBITDA margin (defined as EBITDA divided by total operating revenue) of 56.0%. Our cash flows from operating activities increased by 13.3% to RMB37,102 million in 2002.

- (1) Our EBITDA represents profit before net finance (costs)/income, investment income, share of profit from associates, taxation, depreciation and amortisation and minority interests. As the telecommunications business is a capital-intensive industry, capital expenditures, 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 like us. Although EBITDA is widely used in the global telecommunications industry as a benchmark to reflect operating performance, financing 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 cash flows 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

The table below sets forth our total operating revenue, operating expenses, operating income, net income and cash flows from operating activities in terms of amount and as a percentage of our total operating revenue for 2001 and 2002:

	Year Ended 31 December			
	2001		2002	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)				
Operating revenue	68,546	100.0%	75,496	100.0%
Operating expenses	50,448	73.6%	54,118	71.7%
Operating income	18,098	26.4%	21,378	28.3%
Net income	6,883	10.0%	16,864	22.3%
Cash flows from operating activities	32,761	—	37,102	—

Operating Revenue

Our total operating revenue grew by RMB6,950 million, or 10.1%, from RMB68,546 million in 2001 to RMB75,496 million in 2002. Driven by the continued expansion of our wireline telephone subscriber base and a higher proportion of high-end subscribers, revenue from our local telephone services grew 12.1%. Although revenue from our long distance telephone services decreased by 2.3% due to an increase in the proportion of lower

priced VoIP services usage and increased competition, the rate of decline decelerated from that of 2001. Fuelled by the surge in broadband subscribers and continued growth in managed data services, our total revenue from Internet and managed data services increased by 53.4% from that of 2001 to account for 7.4% of our total operating revenue in 2002. Revenue from leased line services, interconnection and other services also maintained positive growth.



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

The following table sets forth a breakdown of our operating revenue in terms of amount and as a percentage of our total operating revenue for 2001 and 2002:

	Year Ended 31 December			
	2001		2002	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)				
Wireline telephone services⁽¹⁾				
Local:				
Installation fees	780	1.1%	995	1.3%
Monthly fees	10,186	14.9%	12,460	16.5%
Local usage fees	21,004	30.6%	22,392	29.7%
Sub-total	31,970	46.6%	35,847	47.5%
Domestic long distance ⁽²⁾	14,676	21.4%	14,365	19.0%
International, Hong Kong, Macau and Taiwan long distance ⁽²⁾	3,392	4.9%	3,285	4.3%
Interconnections	3,814	5.6%	4,363	5.8%
Upfront connection fees	6,290	9.2%	6,018	8.0%
Sub-total	60,142	87.7%	63,878	84.6%
Data and Internet services:				
Internet	2,150	3.1%	3,775	5.0%
Managed data	1,477	2.2%	1,789	2.4%
Sub-total	3,627	5.3%	5,564	7.4%
Leased line services	2,862	4.2%	3,095	4.1%
Other services⁽³⁾	1,915	2.8%	2,959	3.9%
Total operating revenue	68,546	100.0%	75,496	100.0%

(1) Includes revenue from our registered subscribers, public telephones and prepaid calling cards services.

(2) Includes revenue from our VoIP long distance services.

(3) Includes primarily revenue from the provision of value-added telecommunications services and the sale and maintenance of certain customer-end equipment.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Local Telephone Services

The position of our local telephone services as the largest revenue source of our wireline services was further enhanced as local revenue grew by 12.1%, from RMB31,970 million in 2001 to RMB35,847 million in 2002. Local telephone services contributed 47.5% of our total operating revenue for 2002, which rose 0.9 percentage points from 46.6% in 2001. The increase in local revenue primarily resulted from increases in revenue from monthly fees and local usage fees driven by subscriber growth. The number of our access lines in service increased by 8.38 million, or 17.3%, from 48.48 million at 31 December 2001 to 56.86 million at 31 December 2002.

- *Installation Fees.* Installation fees received from customers are deferred and amortised over the expected customer relationship period of 10 years. Revenue from the amortised amount of upfront installation fees increased by 27.6%, from RMB780 million in 2001 to RMB995 million in 2002. The increase was primarily due to the rapid increase in the number of our access lines in service in recent years.
- *Monthly Fees.* Monthly fee revenue increased by 22.3%, from RMB10,186 million in 2001 to RMB12,460 million in 2002, primarily due to a 19.3% increase in the average number of our access lines in service, from 44.15 million in 2001 to 52.67 million in 2002.
- *Local Usage Fees.* Revenue from local usage increased by 6.6%, from RMB21,004 million in 2001 to RMB22,392 million in 2002. The increase was primarily due to an increase in local telephone usage volume (including dial-up usage), which increased by 6.7%, from 212.4 billion pulses in 2001 to 226.6 billion pulses in 2002.

Long Distance Telephone Services

Revenue from long distance telephone services decreased by 2.3%, from RMB18,068 million in 2001 to RMB17,650 million in 2002, primarily due to a higher proportion of the lower priced VoIP services to total long distance telephone usage. The rate at which revenue decreased, however, was lower than that of 2001.

- *Domestic Long Distance Services.* Domestic long distance revenue decreased by 2.1%, from RMB14,676 million in 2001 to RMB14,365 million in 2002. While total usage of our domestic long distance services increased, it was insufficient to offset the adverse impact of a higher proportion of the substantially lower priced VoIP services to the total usage. Total usage of domestic long distance services (including calls originated from wireline and mobile subscribers) increased by 9.8%, from 30.63 billion minutes in 2001 to 33.62 billion minutes in 2002. Usage of our VoIP domestic long distance services increased as a percentage of the total usage of domestic long distance services, from 37.5% in 2001 to 52.7% in 2002.
- *International Long Distance Services.* Revenue from international long distance services decreased by 3.2%, from RMB3,392 million in 2001 to RMB3,285 million in 2002. This revenue decrease was primarily due to increased competition. Total usage of international long distance services (including calls originated from wireline and mobile subscribers) decreased by 5.8%, from 1.41 billion minutes in 2001 to 1.33 billion minutes in 2002.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Internet and Managed Data Services

Our service regions are among the most prosperous areas in China. Demand for our Internet and managed data services from business and residential subscribers continued to increase, and particularly, our broadband subscriber base experienced substantial growth. Altogether, Internet and managed data service revenue grew 53.4%, from RMB3,627 million in 2001 to RMB5,564 million in 2002, and accounted for 7.4% of our total operating revenue in 2002. We expect such revenue will continue to increase as our subscriber base and usage of our Internet and managed data services continue to grow.

- *Internet Services.* Internet access services revenue increased by 75.6%, or RMB1,625 million, from RMB2,150 million in 2001 to RMB3,775 million in 2002. While usage of dial-up Internet services decreased, strong growth in broadband subscription was the key driver of the boost in Internet revenue. Our broadband subscribers (primarily ADSL and LAN subscribers) increased by 982,000, or 247.4%, to 1,379,000 at the end of 2002. Broadband service has emerged as a major contributor to our revenue growth.
- *Managed Data Services.* Driven primarily by growth in the usage of our services, revenue from managed data services increased by 21.1%, from RMB1,477 million in 2001 to RMB1,789 million in 2002. The total leased bandwidth of our DDN services was 207,700 x 64Kbps at 31 December 2002, representing an increase of 31.0% from that at 31 December 2001. The total leased bandwidth of our ATM services was 10,800 x 2Mbps at 31 December 2002, representing an increase of 38.5% from that at 31 December 2001, and the total

leased bandwidth of our frame relay services was 24,300 x 128Kbps at 31 December 2002, representing an increase of 19.1% from that at 31 December 2001.

Leased Line, Interconnection and Other Services

- *Leased Line Services.* Revenue from leased line services increased by 8.1%, from RMB2,862 million in 2001 to RMB3,095 million in 2002. This increase was fuelled by a 12.0% increase in bandwidth of digital circuits leased, which amounted to 94,400 x 2Mbps at the end of 2002.
- *Interconnection Services.* Revenue from interconnection fees increased by 14.4%, from RMB3,814 million in 2001 to RMB4,363 million in 2002. This increase primarily reflected the settlement revenue we began to receive from China Telecom Group and international operators under our interconnection agreement with China Telecom Group and our arrangement with China Telecom Group for apportionment of international settlement with effect from 1 January 2002, which amounted to RMB1,954 million in 2002. This increase was partially offset by a decrease in interconnection revenue from other operators of RMB1,405 million.
- *Other Services.* Revenue from other services increased by 54.5%, from RMB1,915 million in 2001 to RMB2,959 million in 2002, primarily due to the rapid growth in our value-added telephone services and revenue from the sale and rental of customer-end equipment. The contribution of these services to total operating revenue increased from 2.8% in 2001 to 3.9% in 2002.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Upfront Connection Fees

Upfront connection fees represent the upfront fees received for the initial activation of wireline services, amortised over the expected customer

relationship period of 10 years. Effective from 1 July 2001, we ceased charging upfront connection fees to new subscribers. Consequently, the amortised amount decreased by 4.3%, from RMB6,290 million in 2001 to RMB6,018 million in 2002.

The table below sets forth the amortisation of our upfront connection fees for each of the years from 2003 to 2011 based on a 10-year estimated amortisation period:

	Year Ended 31 December								
	2003	2004	2005	2006	2007	2008	2009	2010	2011
	(RMB in millions)								
Amortisation of upfront connection fees	5,535	4,784	3,842	2,815	1,886	1,158	646	274	53

Operating Expenses

In 2002, we took the initiative to centralise our financial and budget management, equipment procurement, billing, network resource allocation and network maintenance to improve the efficiency of our resource utilisation, to rationalise our cost structure and to keep operating expenses under control.

Our operating expenses increased by 7.3%, from RMB50,448 million in 2001 to RMB54,118 million in 2002. While personnel and interconnection expenses experienced significant increases, depreciation and amortisation expenses grew moderately. Moreover, we maintained the level of selling, general and administrative expenses and significantly reduced network operations and support expenses.



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

The following table breaks down our operating expenses in terms of amount and as a percentage of our total operating revenue for 2001 and 2002:

	Year Ended 31 December			
	2001		2002	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)				
Depreciation and amortisation	19,451	28.4%	20,882	27.7%
Network operations and support ⁽¹⁾	16,477	24.0%	14,724	19.5%
Selling, general and administrative ⁽¹⁾	6,986	10.2%	6,960	9.2%
Personnel	6,207	9.1%	8,915	11.8%
Interconnection charges and other expenses	1,327	1.9%	2,637	3.5%
Total operating expenses	50,448	73.6%	54,118	71.7%

(1) Does not include personnel expenses.

Depreciation and Amortisation. Our depreciation and amortisation expenses increased by 7.4%, from RMB19,451 million in 2001 to RMB20,882 million in 2002, mainly due to increases in capital expenditures in recent years. In 2002, we tightened control over capital expenditures. As a result, the rate at which depreciation and amortisation expenses increased was lower than the 11.9% increase in 2001 compared to 2000 and the amount of depreciation and amortisation expenses as a percentage of total operating revenue dropped by 0.7 percentage points as compared with 2001.

Network Operations and Support. In 2002, we further centralised network maintenance and resource allocation to improve efficiency and network utilisation, thereby trimming our network operations and support expenses (excluding related personnel expenses) by 10.6%, from RMB16,477 million in 2001 to RMB14,724 million in 2002. This decrease was mainly due to a 22.4% decrease in our maintenance expenses, from RMB10,225 million in 2001 to RMB7,937 million in 2002.

Selling, General and Administrative Expenses. Despite the continued expansion of our customer base, our selling, general and administrative expenses (excluding related personnel expenses) dropped slightly to RMB6,960 million in 2002 from RMB6,986 million in 2001. This reflected our improved operating efficiency and the benefits of economies of scale. Selling and marketing expenses decreased by 1.8%, from RMB3,074 million in 2001 to RMB3,019 million in 2002. General and administrative expenses increased by 0.7%, from RMB3,912 million in 2001 to RMB3,941 million in 2002.

Personnel Expenses. Our personnel expenses increased by 43.6%, from RMB6,207 million in 2001 to RMB8,915 million in 2002. This increase was primarily due to the enhancement of our merit-based compensation system to retain and motivate competent personnel, and to bring our compensation in line with that of market level. We believe such a system helps improve our corporate competitiveness.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Interconnection Charges and Other Expenses.

Interconnection and other expenses increased by 98.7%, from RMB1,327 million in 2001 to RMB2,637 million in 2002. This increase was primarily due to the settlement expenses we began to pay to China Telecom Group and international operators under our interconnection agreement with China Telecom Group and our arrangement with China Telecom Group for apportionment of international settlement with effect from 1 January 2002, which amounted to RMB2,160 million in 2002. This increase was partially offset by a decrease in domestic interconnection expenses payable to other operators of RMB842 million.

Net Finance Costs/(Income)

Caused primarily by a change in net foreign exchange differences, we had net finance costs of RMB632 million in 2002 as opposed to net finance income of RMB293 million in 2001. We experienced a net foreign exchange loss of RMB221 million in 2002, as compared to a net foreign exchange gain of RMB430 million in 2001. In addition, while our gross interest expense in 2002 decreased by RMB94 million from 2001 as a result of the repayment of bank loans, net interest expense increased from RMB383 million in 2001 to RMB551 million in 2002. This increase was primarily due to a reduction in the amount of capitalised interest of RMB262 million following a decrease in our capital expenditures.

Income Tax

Our statutory income tax rate is 33%. In 2002, our income tax expense was RMB3,855 million, representing an effective tax rate of 18.5%. The difference between the statutory tax rate and our effective tax rate was primarily due to the preferential income tax rate of 15% applied to some of our subsidiaries located in special economic zones in China and the exclusion of the upfront connection fees and part of the usage fees from taxable revenue. See note 24 to the audited financial statements included elsewhere in this annual report for further details in respect of the reconciliation of our effective tax rate to the statutory tax rate.

Net Income

In 2002, we surpassed the profit forecast set out in our initial public offering prospectus. Driven by steady revenue growth, coupled with the effective control over operating expenses, our net income reached RMB16,864 million.

Capital Expenditures

Our capital expenditures decreased by 27.8%, from RMB40,028 million in 2001 to RMB28,919 million in 2002.



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

The table below sets forth our historical and planned capital expenditures for the years indicated. Actual capital expenditures for the years after 31 December 2002 may differ from the amounts indicated below.

	Year Ended 31 December				
	2000	2001	2002	2003 (Planned)	2004 (Planned)
	(RMB in millions)				
Total capital expenditures	34,310	40,028	28,919	25,000	23,500

The advanced and expansive network infrastructure we built in recent years, together with the improved utilisation of these resources, allowed us the flexibility to substantially decrease our capital expenditure in 2002.

We further rationalised the allocation of our capital expenditures in 2002. We continued to allocate a majority of our capital expenditures to the development of access infrastructure in order to meet subscriber growth needs and to strengthen our position as the owner of the "last mile". Internet and data networks were another major area of capital expenditure as we capitalised on the surging demand for broadband, managed data and Internet services. In addition, we increased expenditures for our Business Support System (BSS), Operation Support System (OSS) and Management Support System (MSS) as part of our effort to improve customer service quality, operating efficiency and information disclosure.

We expect to fund our capital expenditure needs through a combination of cash generated from operating activities, short-term and long-term bank loans and other debt and equity financing. We believe we will have sufficient resources to meet our capital expenditure requirements for the foreseeable future.

Liquidity and Capital Resources

Cash Flows

We experienced a net cash inflow of RMB12,541 million in 2002 as opposed to a net cash outflow of RMB9,979 million in 2001. We raised RMB10,659 million from the initial public offering of our shares in international capital markets in the fourth quarter of 2002. Furthermore, our net cash flow benefited from an increase in cash flows from operating activities and a substantial reduction in capital expenditures.

The table below summarises our cash flows for 2001 and 2002.

	Year Ended 31 December	
	2001	2002
	(RMB in millions)	
Cash flows from operating activities	32,761	37,102
Net cash used in investing activities	(35,399)	(29,095)
Net cash (used in)/ from financing activities	(7,341)	4,534
(Decrease)/increase in cash and cash equivalents	(9,979)	12,541

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Our principal source of liquidity is cash flows from operating activities. In 2002, cash flows from operating activities was RMB37,102 million, representing an increase of RMB4,341 million from RMB32,761 million in 2001. This increase was mainly due to an RMB1,603 million increase in cash generated from operations and a RMB2,973 million decrease in income tax paid.

Stemming from a substantial decrease in capital expenditures, net cash used in investing activities fell by RMB6,304 million, from RMB35,399 million in 2001 to RMB29,095 million in 2002.

Net cash from financing activities was RMB4,534 million in 2002, while net cash used in financing activities was RMB7,341 million in 2001. This change was primarily due to the net proceeds of RMB10,659 million we raised from the initial public offering of our shares in the fourth quarter of 2002. This cash inflow was offset by the substantial amount of bank loans we were able to repay, given the significant increase in cash flows from operating activities and the substantial decrease in our capital expenditures. As a result, net cash flow from bank debt (proceeds from bank debts minus repayments of bank debts) changed from a net cash inflow of RMB4,444 million in 2001 to a net cash outflow of RMB3,529 million in 2002. See our audited financial statements included elsewhere in this annual report for further details of net cash from financing activities.

Working Capital

Our working capital (defined as total current assets minus total current liabilities) was a deficit of RMB31,125 million at 31 December 2002 and a deficit of RMB43,316 million at 31 December 2001. The reduction in working capital deficit in 2002 was primarily the result of the net proceeds of RMB10,659 million we received from the initial public offering of our shares. In addition, from 31 December 2001 to 31 December 2002, our net accounts receivable increased by RMB353 million, and our accounts payable decreased by RMB520 million.

Our cash and cash equivalents were RMB16,423 million at 31 December 2002, of which 70.2%, 23.4% and 6.4% were denominated in Renminbi, US dollars and Hong Kong dollars, respectively.

Indebtedness

Our indebtedness at 31 December 2001 and 2002 was as follows:

	2001	2002
	(RMB in millions)	
Short-term debt	18,827	19,175
Current portion of long-term debt	3,621	2,219
Long-term debt, excluding current portion	7,101	4,853
Total debt	29,549	26,247

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

With the benefit of increased cash flows from operating activities and decreased amount of cash used in investing activities, we paid off a significant amount of bank loans. This, together with the proceeds from the initial public offering of our shares, has strengthened our capital structure. Our debt-to-asset ratio (defined as total debt divided by total assets) declined from 15.6% at 31 December 2001 to 12.4% at 31 December 2002. This has provided us with a solid foundation for continuing organic and external growth.

In 2002, we further centralised cash management to boost efficiency. Our total debt was reduced by RMB3,302 million to RMB26,247 million at 31

December 2002, of which 84.0%, 10.0% and 6.0% were denominated in Renminbi, Japanese Yen and US dollars, respectively.

Having established and maintained high credit ratings at major commercial banks in the PRC, we have been able to obtain adequate debt financing on preferable terms. In 2002, we fine-tuned our debt financing strategy to achieve the dual objectives of reducing financing costs and managing financial risks. The weighted average interest rate of our short-term debt was 4.7% at 31 December 2002, representing an 80 basis points decrease from that at 31 December 2001.

Contractual Obligations

The following table sets forth our contractual obligations at 31 December 2002:

	Total	Repayable in				
		2003	2004	2005	2006	Thereafter
(RMB in millions)						
Short-term debt	19,175	19,175	—	—	—	—
Long-term debt	7,072	2,219	1,196	825	268	2,564
Operating lease commitments	1,438	457	355	114	75	437
Capital commitments	4,239	4,239	—	—	—	—
Guarantees	6	6	—	—	—	—
Total contractual obligations	31,930	26,096	1,551	939	343	3,001

We will continue to pursue steady revenue growth, implement prudent financial management policies, control operating expenses, rationalise our cost structure, reduce capital expenditures and enhance the investment return of our capital projects. We are confident in our ability to create higher value for our shareholders.

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