

↑ 35%

In 2007, value added and integrated information application services revenue sharply increased by 35%



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driving transformation,

driving value



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driving value

Satisfying the diverse needs of our customers in their everyday life by our innovative information search and booking services



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

Summary

On 30 June 2007, the Company completed its acquisition from China Telecommunications Corporation of the entire equity interests in China Telecom System Integration Co. Ltd., China Telecom (Hong Kong) International Limited and China Telecom (Americas) Corporation (formerly known as "China Telecom (USA) Corporation") (collectively the "Third Acquired Group"). Since the Company and the Third Acquired Group were under the common control of China Telecommunications Corporation, our acquisition of the Third Acquired Group has been treated as a

"combination of entities under common control", and was accounted for in a manner similar to a pooling-of-interests ("as-if-pooling-of-interests accounting"). Accordingly, the assets and liabilities of the Third Acquired Group have been accounted for based on their historical amounts and our financial statements for the period prior to the acquisition have been restated to include the financial position and results of operations of the Third Acquired Group on a combined basis. Unless otherwise indicated in this section, our financial data for the period prior to the acquisition are presented based on those restated amounts.

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Our operating revenues in 2007 were RMB178,656 million, representing an increase of 1.7% from 2006. Our operating expenses in 2007 were RMB141,645 million, representing an increase of 3.3% from 2006. Profit attributable to equity holders of the Company in 2007 was RMB23,702 million. In 2007, our basic earnings per share were RMB0.29, EBITDA¹ was RMB89,268 million and EBITDA margin was 50.0%.

Excluding the amortisation of upfront connection fees, deficit on revaluation of property, plant and equipment and related tax effect² (the revaluation was carried out at least once every three years), our operating revenues in 2007 were RMB175,362 million, representing an increase of 2.8% from 2006; profit attributable to equity holders of the Company in 2007 was RMB22,517 million, representing an increase of 1.1% from 2006; basic earnings per share were RMB0.28; EBITDA was RMB85,974 million and EBITDA margin was 49.0%.

Operating Revenues

Our operating revenues in 2007 were RMB178,656 million, representing an increase of 1.7% from 2006. Excluding the amortisation of upfront connection fees, our total operating revenues in 2007 were RMB175,362 million, representing an increase of RMB4,717 million or 2.8% from 2006. Revenue from Internet access services, and value-added and integrated information application services increased by RMB7,616 million and RMB5,028 million from 2006 respectively, which represented the major sources of revenue growth. Revenues from leased line services and other businesses increased by RMB773 million and RMB966 million from 2006 respectively. Revenue from managed data services remained at a similar level as 2006. Revenues from local telephone services and long distance services continued to decrease.

¹ Our EBITDA refers to profit before net finance costs, investment income, share of profits of associates, income tax, depreciation and amortisation, deficit on revaluation of property, plant and equipment and minority interests. 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 like us. Although EBITDA has been widely applied in the global telecommunications industry as a benchmark to reflect the 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.

² In accordance with the Group's accounting policy, the property, plant and equipment of the Group as at 31 December 2007 were revalued for each asset class by the Company (which was carried out at least once every three years) on a depreciated replacement cost basis. The property, plant and equipment as at 31 December 2007 was revalued at RMB326,123 million. The surplus on revaluation of certain property, plant and equipment totalling RMB4,809 million was credited to the revaluation reserve while the deficit on revaluation of certain property, plant and equipment totalling RMB2,755 million was recognised as an expense for the year ended 31 December 2007.

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The following table sets forth a breakdown of our operating revenues for 2006 and 2007, together with their respective rates of change:

| | For the year ended | | |
|--|--|---------|----------|
| | 31 December | 2006 | Rates of |
| | 2007 | | Change |
| | <i>(RMB in millions, except percentage data)</i> | | |
| Wireline telephone services ³ | | | |
| Local | | | |
| Installation fees | 2,735 | 2,913 | (6.1%) |
| Monthly fees | 25,346 | 28,973 | (12.5%) |
| Local usage fees | 42,343 | 46,188 | (8.3%) |
| Subtotal | 70,424 | 78,074 | (9.8%) |
| Domestic long distance | | | |
| International, Hong Kong, Macau and | 24,127 | 25,517 | (5.4%) |
| Taiwan long distance | 2,882 | 3,225 | (10.6%) |
| Interconnections | 13,879 | 14,095 | (1.5%) |
| Subtotal | 40,888 | 42,837 | (4.5%) |
| Internet access services | | | |
| Value-added and integrated information | 31,340 | 23,724 | 32.1% |
| application services | 19,231 | 14,203 | 35.4% |
| Managed data | 3,013 | 3,080 | (2.2%) |
| Leased line services and others ⁴ | 10,466 | 8,727 | 19.9% |
| Operating revenues (excluding amortisation | | | |
| of upfront connection fees) | 175,362 | 170,645 | 2.8% |
| Upfront connection fees | 3,294 | 4,971 | (33.7%) |
| Total operating revenues | 178,656 | 175,616 | 1.7% |

³ Including revenue from our registered subscribers, public telephones and pre-paid calling cards services.

⁴ Including primarily revenue from business customers for the lease of wireline telecommunications network facilities, sales and repairs and maintenance of customer-end equipment and construction of telecommunications network and infrastructure for customers.

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Local Telephone Services

In 2007, revenue from our local telephone services was RMB70,424 million, representing a decrease of 9.8% from RMB78,074 million in 2006 and accounting for 39.4% of our operating revenues, or 40.2% of our operating revenues after deducting amortisation of upfront connection fees. The major reason for this decrease in revenue was that mobile service has further exacerbated the diversion from wireline services due to the continued decline in tariffs for mobile services, which narrowed the gap between mobile service tariffs and wireline service tariffs.

Installation fees

Upfront installation fees are amortised over the expected customer relationship period of 10 years. Revenue from installation fees decreased by 6.1% from RMB2,913 million in 2006 to RMB2,735 million in 2007.

Monthly fees

Revenue from monthly fees in 2007 was RMB25,346 million, representing a decrease of 12.5% from RMB28,973 million in 2006. The major reason for this decrease in revenue was the reduction in monthly fees rate in response to market competition.

Local usage fees

Revenue from local usage fees in 2007 was RMB42,343 million, representing a decrease of 8.3% from RMB46,188 million in 2006. Local voice usage volume in 2007 reached 406,268 million pulses, representing a decrease of 3.9% from 2006. The decrease in revenue was mainly due to the intensifying mobile substitution, the diversification of the means of communication and the decline in average fees.

Long Distance Telephone Services

In 2007, revenue from our long distance telephone services was RMB27,009 million, representing a decrease of 6.0% from RMB28,742 million in 2006, accounting for 15.1% of our operating revenues, or 15.4% of our operating revenues excluding the amortisation of upfront connection fees.

Domestic long distance services

In 2007, revenue from our domestic long distance services was RMB24,127 million, representing a decrease of 5.4% from RMB25,517 million in 2006, while domestic long distance telephone usage volume was 98,251 million minutes, representing an increase by 2.8% from 95,567 million minutes in 2006. The decrease in revenue was attributable to a decrease in average unit price from RMB0.27 per minute in 2006 to RMB0.25 per minute in 2007.

International, Hong Kong, Macau and Taiwan long distance services

In 2007, revenue from our international, Hong Kong, Macau and Taiwan long distance services was RMB2,882 million, representing a decrease of 10.6% from RMB3,225 million in 2006. The decrease in revenue was mainly attributable to the decrease in average unit price of international, Hong Kong, Macau and Taiwan long distance services by 10.0% from RMB2.01 per minute in 2006 to RMB1.81 per minute in 2007.

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Interconnection Services

In 2007, revenue from our interconnection services was RMB13,879 million, representing a decrease of 1.5% from RMB14,095 million in 2006, accounting for 7.8% of our operating revenues, or 7.9% of our operating revenues excluding the amortisation of upfront connection fees. Decrease in such revenue was mainly attributable to the Calling-Party-Pay scheme offered by mobile operators and the increasing diversion of voice usage volume to growing mobile networks.

Internet Access Services

In 2007, revenue from our Internet access services was RMB31,340 million, which grew by 32.1% from RMB23,724 million in 2006, accounting for 17.5% of our operating revenues, or 17.9% of our operating revenues excluding the amortisation of upfront connection fees. Driven by the continuous expansion of our broadband subscriber base in recent years, our Internet access services sustained a rapid growth. The number of our broadband subscribers increased by 7.33 million, or 25.9% from 2006 to 35.65 million as of the end of December 2007.

Value-Added and Integrated Information Application Services

In 2007, revenue from our value-added and integrated information application services was RMB19,231 million, representing an increase of 35.4% from RMB14,203 million in 2006, accounting for 10.8% of our operating revenues, or 11.0% of our operating revenues excluding the amortisation of upfront connection fees. The increase in revenue from our value-added and integrated information application services was mainly attributable to the rapid development of our caller ID service, Colour Ring Tone, Internet value-added services, IT services and applications.

Managed Data Services

In 2007, revenue from our managed data services was RMB3,013 million, representing a decrease of 2.2% from RMB3,080 million in 2006.

Leased Line and Other Services

In 2007, revenue from our leased line services and other services was RMB10,466 million, representing an increase of 19.9% from RMB8,727 million in 2006. Revenue from leased line services was RMB5,321 million, representing an increase of 17.0% from RMB4,548 million in 2006, which was mainly due to the increasing demand of customers for network resources.

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Upfront Connection Fees

Upfront connection fees represent the amortised amount of the upfront fees received for the initial activation of wireline services, amortised over the expected customer relationship period of 10 years. Effective from July 2001, we ceased to charge new subscribers upfront connection fees. The amortised amount was RMB3,294 million in 2007, representing a decrease of 33.7% from RMB4,971 million in 2006.

The table below sets forth the amortisation of upfront connection fees from 2008 to 2011 based on an amortisation period of 10 years (with 2011 as the end of the amortisation period):

| | For the year ending 31 December | | | |
|---|---------------------------------|-------|------|------|
| | 2008 | 2009 | 2010 | 2011 |
| | <i>(RMB in millions)</i> | | | |
| Amortisation of upfront connection fees | 2,022 | 1,151 | 497 | 98 |

Operating Expenses

In 2007, our operating expenses were RMB141,645 million, representing an increase of 3.3% from 2006. The ratio of our operating expenses to operating revenues increased from 78.1% in 2006 to 79.3% in 2007, or 80.8% of our operating revenue excluding the amortisation of upfront connection fees, which remained at a similar level as 2006. The following table sets out a breakdown of our operating expenses in 2006 and 2007 and their respective percentage change:

| | For the year ended | | Percentage Change |
|--|--|---------|----------------------|
| | 31 December 2007 | 2006 | |
| | <i>(RMB in millions, except percentage data)</i> | | |
| Depreciation and amortisation | 52,257 | 51,301 | 1.9% |
| Network operations and support expenses | 31,622 | 31,055 | 1.8% |
| Selling, general and administrative expenses | 23,667 | 22,259 | 6.3% |
| Personnel expenses | 27,242 | 26,210 | 3.9% |
| Interconnection and other operating expenses | 6,857 | 6,255 | 9.6% |
| Total operating expenses | 141,645 | 137,080 | 3.3% |

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Depreciation and Amortisation

Our depreciation and amortisation expenses were RMB52,257 million in 2007, representing an increase of 1.9% from 2006, accounting for 29.3% of our total operating revenues. The depreciation and amortisation expenses as a percentage of our operating revenues excluding the amortisation of upfront connection fees decreased from 30.1% in 2006 to 29.8% in 2007.

Network Operations and Support Expenses

Our network operations and support expenses were RMB31,622 million in 2007, representing an increase of 1.8% from RMB31,055 million in 2006, accounting for 17.7% of our total operating revenues, or 18.0% of our total operating revenues excluding the amortisation of upfront connection fees. Such increase was mainly attributable to the increase in electricity prices and increase in costs in transforming businesses such as IT services and applications.

Selling, General and Administrative Expenses

In 2007, our selling, general and administrative expenses amounted to RMB23,667 million, representing an increase of 6.3% from RMB22,259 million in 2006, accounting for 13.2% of our operating revenues, or 13.5% of our operating revenues excluding the amortisation of upfront connection fees. This increase was mainly attributable to additional sales and marketing expenses in relation to brand management, development of transforming businesses and retaining subscriber base.

Personnel Expenses

In 2007, our personnel expenses were RMB27,242 million, representing an increase of 3.9% from RMB26,210 million in 2006. Such increase was mainly attributable to the maintenance of the Company's effective incentive scheme and the recruitment of more talented professional personnel to IP, IT and information services operations in line with strategic transformation needs, among other considerations. Our personnel expenses in 2007 account for 15.2% of our operating revenues, and 15.5% of our operating revenues excluding the amortisation of upfront connection fees, which was similar to that in 2006.

Interconnection and Other Operating Expenses

The Company's interconnection and other expenses increased by 9.6% from RMB6,255 million in 2006 to RMB6,857 million in 2007. Increase in long distance voice interconnections driven by Calling-Party-Pay scheme of mobile services was the major reason for the increase in interconnection expenses. Our net revenue from interconnections (interconnection revenue less interconnection expenses) in 2007 amounted to RMB7,119 million, representing a decrease of 9.7% from 2006.

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Net Finance Costs

In 2007, the Company's net finance costs were RMB4,300 million, representing a decrease of 4.2% from RMB4,489 million in 2006, in which net exchange gain was RMB105 million, which was similar to 2006. Our interest expenses decreased by RMB594 million. Such decrease was mainly attributable to our repayment of matured interest-bearing debts.

Revaluation of Property, Plant and Equipment

In accordance with the Group's accounting policy, the property, plant and equipment of the Group as at 31 December 2007 were revalued for each asset class by the Company (which was carried out at least once every three years) on a depreciated replacement cost basis. The property, plant and equipment as at 31 December 2007 was revalued at RMB326,123 million. The surplus on revaluation of certain property, plant and equipment totalling RMB4,809 million was credited to the revaluation reserve while the deficit on revaluation of certain property, plant and equipment totalling RMB2,755 million was recognised as an expense for the year ended 31 December 2007. The surplus was mainly attributable to an increase in the prices of properties. The deficit was mainly due to a decrease in the prices of equipment resulting from the technological advancement.

Income Tax

The Company's statutory income tax rate is 33%. In 2007, the Company's income tax expenses were RMB6,452 million, and effective income tax rate was 21.3%, whereas the effective income tax rate for the Company's income tax expenses excluding the upfront connection fees was 23.9%. The difference between the effective income tax rate and the statutory income tax rate was mainly attributable to the exclusion of upfront connection fees from taxable revenue, and the preferential income tax rate of 15% enjoyed by our operating subsidiaries located in special economic zones and in the western part of China. Another reason for our effective tax rate being lower than the statutory tax rate was that some of our operating subsidiaries received tax credits of RMB1,319 million on the purchases of domestic equipment in 2007. Under the new taxation law, the previous tax rate of 33% applicable on the Company and a number of subsidiaries has been reduced to 25% effective from 1 January 2008. The tax authorities will no longer assess and approve any tax credit for domestic equipment purchases from 2008 onwards.

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Profit Attributable to Equity Holders of the Company

In 2007, the profit attributable to equity holders of the Company reached RMB23,702 million, representing a decrease of 13.0% from RMB27,241 million in 2006. Excluding the amortisation of upfront connection fees, deficit on revaluation of property, plant and equipment and related tax effect (which was carried out at least once every three years), the profit attributable to equity holders of the Company was RMB22,517 million, representing an increase of 1.1% from RMB22,270 million in 2006. The Company has continued to maintain a good level of operating efficiency and profitability.

Capital Expenditure

In 2007, the Company continued with its prudent policy on capital expenditure. Capital expenditure was RMB45,558 million, representing a decrease of 7.2% from RMB49,116 million in 2006. In order to implement changes in the Company's strategic transformation, we have effectively controlled the scale of our capital expenditure and optimised our investment structure. We have significantly reduced our capital expenditure in connection with traditional fixed line voice businesses and telecommunications infrastructure, and increased our investment in broadband access and data network.

In 2008, our estimated capital expenditure is approximately RMB45,000 million. The main sources of our capital are cash generated from operating activities, bank borrowings and other indebtedness. We expect that we will have sufficient funding sources to meet our capital expenditure requirements in the future.

Cash Flows and Capital Resources Cash Flows

In 2007, net cash outflow of the Company was RMB1,838 million, while its net cash inflow was RMB4,053 million in 2006.

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The following table sets out our cash flow information in 2006 and 2007:

| | For the year ended 31 December | |
|--|---|----------|
| | 2007 | 2006 |
| | <i>(RMB in millions)</i> | |
| Net cash flow from operating activities | 74,876 | 74,802 |
| Net cash used in investing activities | (46,209) | (50,039) |
| Net cash used in financing activities | (30,505) | (20,710) |
| Net (decrease)/increase in cash and cash equivalents | (1,838) | 4,053 |

In 2007, the net cash flow from our operating activities was RMB74,876 million, which was similar to 2006.

In 2007, we reduced our capital expenditure. Cash used in our investing activities was RMB46,209 million, representing a decrease of RMB3,830 million from 2006.

In 2007, the net cash used in our financing activities was RMB30,505 million while the net cash used in such activities was RMB20,710 million in 2006. The increase in net cash used in our financing activities was mainly due to decreased cash inflow from borrowings as compared to 2006.

Working Capital

By the end of 2007, the Company's working capital (total current assets minus total current liabilities) deficit was RMB95,857 million, representing a decrease of RMB17,566 million from the deficit of RMB113,423 million in 2006. The decrease in deficit was mainly attributable to the repayment of certain short-term debts, long-term debts maturing within one year and accounts payable with the cash flow from operating activities. By the end of 2007, the Company's cash and cash equivalents amounted to RMB20,384 million, of which 92.6% was denominated in RMB.

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Indebtedness

Our indebtedness analysis as of the end of 2006 and 2007 was as follows:

| | As at 31 December | |
|--|--------------------------|---------|
| | 2007 | 2006 |
| | <i>(RMB in millions)</i> | |
| Short-term debt | 67,166 | 79,576 |
| Long-term debt maturing within one year | 3,811 | 8,242 |
| Finance lease obligations | 29 | 48 |
| Long-term debt (excluding current portion) | 34,148 | 37,257 |
| Total debt | 105,154 | 125,123 |

By the end of 2007, total indebtedness of the Company was RMB105,154 million, representing a decrease of RMB19,969 million from 2006. The main reason for the decrease was our repayment of certain borrowings with the cash flow from operating activities.

Therefore, the ratio of the Company's total indebtedness to total assets decreased from 29.9% in 2006 to 25.8% in 2007. The Company believes that it has continued to maintain a solid capital structure.

Most of the Company's revenue receipts and payments made are denominated in Renminbi, and Renminbi is not a freely convertible currency. The Company's loans in Renminbi, US Dollar, Japanese Yen and Euro accounted for 96.5%, 1.0%, 1.7% and 0.8% of the Company's total indebtedness, respectively. 70.6% of our indebtedness was loans with fixed interest rates.

Contractual Obligations

| | Total | 2008 | Payable in | | | |
|--------------------------------------|--------------------------|---------------|-------------------|--------------|--------------|-------------------|
| | | | 2009 | 2010 | 2011 | After 2011 |
| | <i>(RMB in millions)</i> | | | | | |
| Short-term debt | 68,644 | 68,644 | – | – | – | – |
| Long-term debt | 48,524 | 5,539 | 2,407 | 2,600 | 1,786 | 36,192 |
| Finance lease obligations | 29 | 24 | 5 | – | – | – |
| Operating lease commitments | 2,021 | 552 | 369 | 302 | 231 | 567 |
| Capital commitments | 3,573 | 3,573 | – | – | – | – |
| Total contractual obligations | 122,791 | 78,332 | 2,781 | 2,902 | 2,017 | 36,759 |

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

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Pursuant to an Acquisition Agreement entered into by the Company with China Telecom on 31 March 2008, the Company will acquire the entire equity interest in China Telecom Group Beijing Corporation from China Telecom for a total purchase price of RMB5,557 million (hereinafter, referred to as the "Proposed Acquisition"), subject to approvals by independent shareholders of the Company and relevant government and regulatory authorities. Management believes that the Proposed Acquisition will enhance the Group's market position and competitiveness in mainland PRC. As the Company and China Telecom Group Beijing Corporation are under the common control of China Telecom prior to and after the acquisition, the Proposed Acquisition will be accounted for as a combination of entities under common control in a manner similar to a pooling-of-interests upon completion.

EFFECT OF SNOWSTORM

In January and February 2008, certain provinces in China were adversely affected by snowstorm and severe weather conditions, which had impacted the operation of the Company and caused a loss of approximately RMB572 million on assets written-off. In addition, it is expected that an extra capital expenditure of RMB960 million will be required.

The snowstorm had imposed some impact on the Company's revenue and cash expenses. However, we are implementing various measures to further enhance business development and strengthen cost control with a view to mitigating and minimizing the adverse effect.