

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

Summary

The Group, in June 2008, acquired the entire equity interest in China Telecom Group Beijing Corporation ("Beijing Company") for a total consideration of RMB5,557 million from China Telecommunications Corporation. Since the Group and Beijing Company were under common control of China Telecommunications Corporation, the acquisition 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 Beijing Company 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 Beijing Company on a combined basis. Unless otherwise specified in this section, the financial data of the Group for the period prior to the acquisition are presented based on those restated amounts.

According to the acquisition agreement entered into between the Company, China Unicom Limited and China Unicom Corporation Limited (the latter two collectively, the "Unicom Group") in July 2008, the Group, effective from 1 October 2008, has owned and operated the entire CDMA business (including the entire equity interest in China Unicom (Macau) Company Limited and 99.5% of the equity interest in Unicom Huasheng Telecommunications Technology Co. Ltd.) and related assets and liabilities in relation to the CDMA subscribers. The acquisition price was RMB43,800 million and the business combination was accounted for using the purchase method.

The Group's operating revenues in 2008 were RMB186,801 million, representing an increase of 3.3% from 2007. Operating expenses were RMB181,656 million, representing an increase of 26.9% from 2007; profit attributable to equity holders of the Company was RMB884 million, and basic earnings per share were RMB0.01. EBITDA¹ (before CDMA network capacity lease fee of RMB1,504 million) was RMB84,696 million and the EBITDA margin was 45.3%.

Excluding the amortisation of upfront connection fees and the impact of one-off items including impairment loss of the PHS assets and the losses related to natural disasters², the operating revenues of the Group in 2008 were RMB184,779 million, representing an increase of 4.0% from 2007; profit attributable to equity holders of the Company was RMB20,066 million, representing a decrease of 12.8% from 2007³, basic earnings per share was RMB0.25; EBITDA (before CDMA network capacity lease fee) was RMB85,889 million and the EBITDA margin was 46.5%.

¹ Our EBITDA refers to profit before net finance costs, investment income, share of profits of associates, income tax, depreciation and amortisation, impairment loss on property, plant and equipment, CDMA network capacity lease fee 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 Losses related to natural disasters were RMB3,428 million with after-tax effect of RMB2,838 million. Impairment loss of the PHS assets was RMB23,954 million with after-tax effect of RMB18,366 million.

³ Excluding the deficit on revaluation of property, plant and equipment and considering the impact of the acquisition of the Beijing Company, profit attributable to equity holders of the Company was RMB23,010 million for 2007.

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Operating Revenues

In 2008, by continuously adhering to the customer branding operation, strongly promoting the integrated information application services and successfully completing the acquisition and transition of the CDMA business, the Group's operating revenues maintained solid growth. Our operating revenues in 2008 were RMB186,801 million, representing an increase of 3.3% from 2007. Excluding the amortisation of upfront connection fees of RMB2,022 million and total mobile revenue of RMB6,154 million (including revenue from the mobile voice services of RMB3,972 million, mobile value-added services of RMB1,469 million and other mobile services of RMB713 million), our operating revenues in 2008 were RMB178,625 million, representing an increase of 0.6% from 2007. Our wireline services revenue grew steadily, primarily due to fast growth in the non-voice services which offset the decline in the wireline voice services. The ratio of wireline non-voice services revenue to total wireline revenue, excluding the amortisation of upfront connection fees, has increased over the years to 46.1% in 2008, representing an increase of 8.9 percentage points from 2007. With the growth in wireline non-voice revenue, the Group's revenue structure has become further improved and the risk of over-reliance on traditional businesses has been further reduced, enhancing the Group's capacity to manage risks.

The following table sets forth a breakdown of our operating revenues for 2007 and 2008, together with their respective rates of change:

<i>(RMB in millions, except percentage data)</i>	For the year ended 31 December		Rates of Change
	2008	2007	
Wireline voice	96,331	111,625	(13.7%)
Mobile voice	3,972	—	N/A
Internet	40,786	31,817	28.2%
Value-added services	16,274	13,208	23.2%
Integrated information application services	10,853	6,573	65.1%
Managed data and leased line	10,231	9,183	11.4%
Others	6,332	5,182	22.2%
Upfront connection fees	2,022	3,294	(38.6%)
Total operating revenues	186,801	180,882	3.3%

In prior years, the revenues from wireline services including monthly fees, local usage fees, domestic long distance usage fees, International, Hong Kong, Macau and Taiwan long distance usage fees, interconnections, upfront installation fees, managed data and leased line revenue were separately disclosed. The amounts of revenue from value-added services and integrated information application services were not separately disclosed but were disclosed in aggregate under the caption of "value-added and integrated information application service revenue".

In 2008, the Group changed its internal reporting system by aggregating the revenues from wireline services including monthly fees, local usage fees, domestic long distance usage fees, International, Hong Kong, Macau and Taiwan long distance usage fees, interconnections and upfront installation fees as "wireline voice revenue", aggregating the amounts of managed data and leased line revenue as "managed data and leased line revenue" and by separating the amounts of revenue from value-added and integrated information application services as "value-added service revenue" and "integrated information application service revenue".

The related comparative figures have been aggregated or separated to conform with the current year's figures.

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Wireline Voice

In 2008, revenue from our wireline voice services was RMB96,331 million, representing a decrease of 13.7% from RMB111,625 million in 2007, accounting for 51.6% of our operating revenues, or 52.1% of our operating revenues excluding the amortisation of upfront connection fees. The major reason for the continuous decline in wireline voice services revenue was the mobile services and the new means of communication such as VOIP, which further exacerbated the diversion from wireline services.

Mobile Voice

In the fourth quarter of 2008, mobile voice revenue from the CDMA operations was RMB3,972 million, accounting for 2.1% of our operating revenues, or 2.1% of our operating revenues excluding the amortisation of upfront connection fees. Mobile services will become one of the main revenue drivers in our full services integrated operations.

Internet

In 2008, revenue from our internet access services was RMB40,786 million, representing an increase of 28.2% from RMB31,817 million in 2007, accounting for 21.8% of our operating revenues, or 22.1% 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 revenue has sustained rapid growth. The number of broadband subscribers increased to 44.27 million as of the end of 2008, representing an increase of 8.53 million or 23.9% from the end of 2007. At the same time, the ARPU of broadband subscribers in 2008 was RMB83.8, representing an increase of RMB2.4 from RMB81.4 in 2007, remaining at a relatively high level.

Value-added Services

In 2008, revenue from value-added services was RMB16,274 million, representing an increase of 23.2% from RMB13,208 million in 2007, accounting for 8.7% of our operating revenues, or 8.8% of our operating revenues excluding the amortisation of upfront connection fees. The increase in revenue was mainly attributable to the mobile value-added services brought by the acquisition of the CDMA business, and the rapid development of internet value-added services and the "Colour Ring Tone" service of the wireline value-added services, etc. The revenue related to mobile value-added services generated after the acquisition of the CDMA business was RMB1,469 million.

Integrated Information Application Services

In 2008, revenue from our integrated information application services was RMB10,853 million, an increase of 65.1% from RMB6,573 million in 2007, accounting for 5.8% of our operating revenues, or 5.9% of our operating revenues excluding the amortisation of upfront connection fees. The increase in revenue was mainly due to the rapid development of IT service and IT application services, "Best-tone" services, "V-Net" services and video application services, etc.

Managed Data and Leased Line

In 2008, revenues from managed data and leased line services were RMB10,231 million, representing an increase of 11.4% from RMB9,183 million in 2007, accounting for 5.5% of our operating revenues, or 5.5% of our operating revenues excluding the amortisation of upfront connection fees. The increase in revenue was mainly due to increasing revenue growth in leased circuits services and the IP-VPN services, driven by the increasing demand from non-operator customers for network resources.

Others

In 2008, revenue from our other services was RMB6,332 million, representing an increase of 22.2% from RMB5,182 million in 2007, accounting for 3.4% of our operating revenues, or 3.4% of our operating revenues excluding the amortisation of upfront connection fees. The increase in revenue was mainly due to the sales revenue of equipment for system integration and terminal equipment such as handsets. The revenue related to other mobile services generated after the acquisition of the CDMA business was RMB713 million.

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Upfront Connection Fees

Upfront connection fees represent the amortised amount of upfront fees received for initial activation of wireline services of the Group, 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 RMB2,022 million in 2008, representing a decrease of 38.6% from RMB3,294 million in 2007.

The amortisation of upfront connection fees will end in 2011, the amortisation of upfront connection fees for the years ended 2009, 2010 and 2011 will be RMB1,151 million, RMB497 million and RMB98 million respectively.

Operating Expenses

In 2008, the operating expenses of the Group were RMB181,656 million, representing an increase of 26.9% from 2007. The ratio of operating expenses to operating revenues increased to 97.2% from 79.1% in 2007, or increased to 98.3% from 80.6% of operating revenues excluding the amortisation of upfront connection fees in 2007. Excluding the impact of one-off items including impairment loss of the PHS assets and losses related to natural disasters, our operating expenses were RMB154,274 million, or 83.5% of our operating revenues excluding the amortisation of upfront connection fees. The increase in expenses was mainly attributable to additional investment by the Group in transformation services and the mobile services, so as to enhance the Group's competitiveness and ensure its sustainable and healthy development in the future.

The following table sets out a breakdown of our operating expenses in 2007 and 2008 and their respective rates of change:

<i>(RMB in millions, except percentage data)</i>	For the year ended 31 December		Rates of Change
	2008	2007	
Depreciation and amortisation	53,880	52,607	2.4%
Network operations and support expenses	36,096	29,856	20.9%
Selling, general and administrative expenses	27,935	24,294	15.0%
Personnel expenses	28,946	27,419	5.6%
Other operating expenses	10,632	8,965	18.6%
Property, plant and equipment impairment loss which includes:	24,167	—	N/A
Impairment loss of the PHS assets	23,954	—	N/A
Total operating expenses	181,656	143,141	26.9%

Depreciation and Amortisation

Depreciation and amortisation were RMB53,880 million in 2008, representing an increase of 2.4% from RMB52,607 million in 2007, accounting for 28.8% of our operating revenues. The ratio of depreciation and amortisation expenses to our operating revenues excluding the amortisation of upfront connection fees decreased to 29.2% in 2008 from 29.6% in 2007.

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Network Operations and Support Expenses

In 2008, network operations and support expenses were RMB36,096 million, representing an increase of 20.9% from RMB29,856 million in 2007, accounting for 19.3% of our operating revenues, or 19.5% of our operating revenues excluding the amortisation of upfront connection fees. The increase was mainly attributable to the increasing investment by the Group in transformation services, losses from natural disasters, the CDMA network capacity lease fee and the increasing electricity price.

Selling, General and Administrative Expenses

In 2008, selling, general and administrative expenses amounted to RMB27,935 million, representing an increase of 15.0% from RMB24,294 million in 2007, accounting for 15.0% of our operating revenues, or 15.1% of our operating revenues excluding the amortisation of upfront connection fees. This increase was mainly attributable to additional investment in relation to transformation services and the promotion and initial investment in the "e surfing" brand so as to support the Company's strategy of "Customer-focused Innovative Informatisation".

Personnel Expenses

In 2008, personnel expenses were RMB28,946 million, representing an increase of 5.6% from RMB27,419 million in 2007. Personnel expenses accounted for 15.5% of our operating revenues, or 15.7% of our operating revenues excluding the amortisation of upfront connection fees. The increase in personnel expenses was mainly attributable to the inclusion of new employees from the Unicom Group as well as the recruitment of professional personnel for our mobile communications, IP, IT and information operations, to meet the needs of the Group's full services integrated operations.

Other Operating Expenses

Other operating expenses primarily included expenses from interconnections settlement and cost of goods sold. The Group's other expenses increased by 18.6% from RMB8,965 million in 2007 to RMB10,632 million in 2008. The increase was mainly attributable to the newly-incurred expenses of mobile interconnection settlement for mobile services operation and increased expenses for sales of terminal equipment, such as handsets.

Impairment Loss on Property, Plant and Equipment

In accordance with the requirements of the International Financial Reporting Standards (IFRS), and considering the impact of the mobile development strategy on our PHS service upon the full services integrated operations of the Group, we have estimated a significant drop in the cash flow generation capability of our PHS assets. The Group carried out impairment tests of the PHS assets at the end of 2008 and recognised an impairment loss of RMB23,954 million.

Net Finance Costs

In 2008, the Group's net finance costs were RMB5,076 million, representing an increase of 18.4% from RMB4,288 million in 2007, in which net interest expenses increased by RMB564 million under the influence of interest rate increases at the end of 2007 and in the first half of 2008. Exchange loss was RMB170 million, while the exchange gain was RMB104 million in 2007. The change of net exchange gain/loss was mainly attributable to the depreciation of RMB against the Japanese Yen.

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Profitability Level

Income Tax

The Group's statutory income tax rate is 25%. In 2008, the Group's income tax expenses were RMB793 million, with the effective income tax rate excluding upfront connection fees being 21.1% after excluding the impact of one-off items including impairment loss of the PHS assets and losses related to natural disasters. 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% or 18% enjoyed by our branches located in special economic zones and in the western part of China. Additional reasons for our effective tax rate being lower than the statutory tax rate were the additional deductions of research and development expenses for some of our provincial branches and the tax credits received on the purchase of domestically made equipment before the implementation of the new tax law in 2008.

Profit Attributable to Equity Holders of the Company

In 2008, profit attributable to equity holders of the Company was RMB884 million, representing a decrease of 96.3% from RMB24,195 million in 2007. Excluding the amortisation of upfront connection fees and the impact of one-off items including impairment loss of the PHS assets and the impact of natural disasters, the profit attributable to equity holders of the Company was RMB20,066 million, representing a decrease of 12.8% from 2007.

Capital Expenditure and Cash Flows

Capital Expenditure

In 2008, the Group continued with its prudent policy on capital expenditure. Capital expenditure was RMB48,410 million, representing an increase of 4.5% from RMB46,334 million in 2007 mainly due to the impact of natural disasters.

Cash Flows

In 2008, net cash inflow of the Group was RMB6,522 million, while the net cash outflow was RMB1,582 million in 2007.

The following table sets out our cash flow position in 2007 and 2008:

<i>(RMB in millions)</i>	For the year ended 31 December	
	2008	2007
Net cash flow from operating activities	76,756	75,783
Net cash used in investing activities	(75,819)	(46,618)
Net cash flow from/(used in) financing activities	5,585	(30,747)
Net increase/(decrease) in cash and cash equivalents	6,522	(1,582)

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In 2008, the net cash flow from operating activities was RMB76,756 million, representing an increase of RMB973 million from RMB75,783 million in 2007.

In 2008, net cash used in investing activities was RMB75,819 million, representing an increase of RMB29,201 million from 2007, mainly resulting from the payment for the acquisition of the Unicom Group's CDMA business by the Group.

In 2008, the net cash inflow from financing activities was RMB5,585 million while the net cash outflow was RMB30,747 million in 2007. The increase in net cash inflow was mainly due to the issue of short-term commercial paper and medium term notes totaling RMB30,000 million by the Group.

Working Capital

At the end of 2008, the Group's working capital (total current assets minus total current liabilities) deficit was RMB121,291 million, representing an increase of RMB25,156 million from the deficit of RMB96,135 million in 2007. The deficit increase was mainly attributable to new short-term debt, such as short-term commercial paper. As at the end of 2008, the Group's cash and cash equivalents amounted to RMB27,866 million, of which 94.2% (2007: 93.0%) was denominated in RMB.

Assets and Liabilities

In 2008, the Group continued to maintain a sound capital structure. As at the end of 2008, the Group's total assets increased to RMB440,337 million from RMB413,331 million as of the end of 2007, while total indebtedness increased to RMB123,279 million from RMB105,755 million as of the end of 2007. The ratio of the Group's total indebtedness to total assets increased from 25.6% as of the end of 2007 to 28.0% as of the end of 2008.

Indebtedness

Our indebtedness analysis as of the end of 2007 and 2008 is as follows:

<i>(RMB in millions)</i>	For the year ended 31 December	
	2008	2007
Short-term debt	83,448	67,767
Long-term debt maturing within one year	565	3,811
Finance lease obligations maturing within one year	22	24
Long-term debt (excluding current portion)	39,226	34,148
Finance lease obligations (excluding current portion)	18	5
Total debt	123,279	105,755

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As of the end of 2008, total indebtedness of the Group was RMB123,279 million, representing an increase of RMB17,524 million from 2007. The main reason for the increase was the issue of short-term commercial paper and medium-term notes by the Group. Of the total indebtedness of the Group, 97.2% (2007: 96.4%) was denominated in Renminbi, 0.7% (2007: 1.0%) was denominated in US Dollar, 1.5% (2007: 1.8%) was denominated in Japanese Yen and 0.6% (2007: 0.8%) was denominated in Euro. 87.2% (2007: 70.7%) of the indebtedness was loans with fixed interest rates while the remaining was with floating rates. As at 31 December 2008, the Group did not (2007: nil) pledge any assets to secure the debts.

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.

As at 31 December 2008, the Group's unutilised committed credit facilities amounted to RMB128,231 million (2007: RMB36,823 million).

Contractual Obligations

<i>(RMB in millions)</i>	Total	Payable in				
		1 Jan 2009– 31 Dec 2009	1 Jan 2010– 31 Dec 2010	1 Jan 2011– 31 Dec 2011	1 Jan 2012– 31 Dec 2012	Thereafter
Short-term debt	85,576	85,576	—	—	—	—
Long-term debt	48,407	2,498	3,558	12,011	1,457	28,883
Finance lease obligations	40	22	18	—	—	—
Operating lease commitments	3,092	830	595	479	380	808
Capital commitments	3,912	3,912	—	—	—	—
Total contractual obligations	141,027	92,838	4,171	12,490	1,837	29,691

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