

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

Summary

In 2011, the Group firmly seized the development opportunities, further deepened the strategic transformation, vigorously developed the mobile, broadband, and industry application services, effectively promoted the scale development of full services operation and continuously improved the profitability of the Group. The Group's operating revenues in 2011 were RMB245,041 million, an increase of 11.5% from 2010; operating expenses were RMB220,912 million, an increase of 12.5% from 2010; profit attributable to equity holders of the Company was RMB16,502 million and basic earnings per share was RMB0.20; EBITDA¹ was RMB94,364 million and the EBITDA margin² was 40.8%.

Excluding the amortisation of upfront connection fees, the operating revenues of the Group in 2011 were RMB244,943 million, an increase of 11.7% from 2010; profit attributable to equity holders of the Company was RMB16,404 million, an increase of 10.5% from RMB14,850³ million in 2010, basic earnings per share was RMB0.20; EBITDA was RMB94,266 million and the EBITDA margin was 40.8%.

Operating Revenues

In 2011, facing the challenges from intense market competition, the Group continued to improve its full services operation standards, transform its mode of development and enhance its comprehensive service. The operating revenues maintained positive growth, and the revenue structure has been further optimised. Operating revenues in 2011 were RMB245,041 million, an increase of 11.5% from 2010. Excluding the amortisation of upfront connection fees of RMB98 million, operating revenues in 2011 were RMB244,943 million, an increase of 11.7% from 2010. Of this, the total mobile revenue was RMB82,701 million, an increase of 53.3% from 2010. The wireline services revenue was RMB162,242 million, a decrease of 1.9% from 2010. The mobile service revenue⁴, wireline broadband revenue, wireline value-added services revenue and integrated information application services revenue accounted for 27.9%, 24.8% and 12.2% of the total operating revenues, respectively. The revenue structure has become more reasonable.

¹ EBITDA was calculated from operating revenue minus operating expenses (which excluded depreciation and amortisation and CDMA network capacity lease fee). 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 analyzing the operating results of a telecommunications service provider such as the Company. Although EBITDA has been widely applied in the global telecommunications industry as a benchmark to reflect operating performance, 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 EBITDA margin was calculated from EBITDA divided by operating revenues excluding the revenue from mobile terminal sales.

³ In 2011, the Group retrospectively adopted the amendment to IFRS 1. Please refer to note 3 of the audited financial statements in this annual report for details.

⁴ Mobile service revenue represents total mobile revenue minus other mobile revenue. Of this, in 2011, other mobile revenue amounted to RMB14,453 million.

The following table sets forth a breakdown of the operating revenues of the Group for 2010 and 2011, together with their respective rates of change:

(RMB in millions, except percentage data)	For the year ended 31 December		Rate of Change
	2011	2010	
Wireline voice	49,764	62,498	(20.4%)
Mobile voice	38,628	28,906	33.6%
Internet	74,992	63,985	17.2%
Value-added services	25,529	22,571	13.1%
Integrated information application services	20,473	15,519	31.9%
Managed data and leased line	14,273	12,389	15.2%
Others	21,284	13,499	57.7%
Upfront connection fees	98	497	(80.3%)
Total operating revenues	245,041	219,864	11.5%

Wireline Voice

As the trend for substitution of wireline voice to mobile and Internet services has intensified, revenue from wireline voice service continued to decrease. In 2011, revenue from wireline voice services was RMB49,764 million, a decrease of 20.4% from RMB62,498 million in 2010, accounting for 20.3% of our operating revenues.

Mobile Voice

The mobile service has maintained rapid growth in 2011. The revenue from mobile voice services was RMB38,628 million, an increase of 33.6% from RMB28,906 million in 2010, accounting for 15.8% of our operating revenues. In 2011, the net increase in the number of mobile subscribers was 35.95 million, reaching 126 million.

Internet

In 2011, revenue from Internet access services was RMB74,992 million, an increase of 17.2% from RMB63,985 million in 2010, accounting for 30.6% of our operating revenues. Through the "Broadband China • Fibre Cities" project, the Group upgraded the network bandwidth, which effectively promoted the rapid growth of broadband service. The revenue from our Internet access services continued to grow. At the end of 2011, the number of wireline broadband subscribers increased by 21.0% to 76.81 million, a net increase of 13.33 million subscribers from the end of 2010. In 2011, the wireline broadband revenue of the Group was RMB60,801 million, an increase of 12.3% from 2010. Revenue from mobile Internet access services was RMB13,301 million, an increase of 47.5% from 2010.

Value-Added Services

In 2011, revenue from value-added services was RMB25,529 million, an increase of 13.1% from RMB22,571 million in 2010, accounting for 10.4% of our operating revenues. The increase in revenue was mainly attributable to the rapid growth of mobile value-added services. Revenue from mobile value-added services was RMB12,067 million, an increase of 53.6% from 2010. However, due to the decline in PAS services, revenue from wireline value-added services decreased by 8.5% when compared with 2010.

Integrated Information Application Services

In 2011, revenue from integrated information application services was RMB20,473 million, an increase of 31.9% from RMB15,519 million in 2010, accounting for 8.4% of our operating revenues. The increase in revenue was mainly due to the rapid development of the IT service and applications services as well as "Best Tone" type of information services. Revenue from mobile integrated information application services was RMB4,172 million, an increase of 117.3% from 2010.

Managed Data and Leased Line

In 2011, revenue from managed data and leased line services was RMB14,273 million, an increase of 15.2% from RMB12,389 million in 2010, accounting for 5.8% of our operating revenues. As the demand from customers for network resources and informatisation continues to increase, the revenue growth from domestic leased circuits services, IP-VPN services and leased optic fibre channel has increased relatively rapidly. Revenue from mobile managed data and leased line services was RMB80 million.

Others

In 2011, revenue from other services was RMB21,284 million, an increase of 57.7% from RMB13,499 million in 2010, accounting for 8.7% of our operating revenues. The growth of revenue was mainly attributable to the sales revenue of mobile terminal equipment. Revenue from other mobile services was RMB14,453 million, an increase of 132.0% from 2010.

Upfront Connection Fees

Upfront connection fees received by the Group from subscribers were amortised over an expected customer relationship period of 10 years. Effective from 1 July 2001, the Group ceased to charge new subscribers upfront connection fees. The termination date for the amortisation of upfront connection fees was 30 June 2011. The amortised amount was RMB98 million in 2011, representing a decrease of 80.3% from RMB497 million in 2010.

Operating Expenses

In order to promote the scale development of full services operation and increase our future competitiveness, the Group has centralised resources deployment, appropriately increased resources input, adhered to tilting more resources towards high growth service, high-value customers and highly-profitable regions. In the meantime, the Group has optimised its precision management, continuously increased the efficiency in the use of resources, and effectively promoted the dual increase in the full services scale and profitability. In 2011, the operating expenses of the Group were RMB220,912 million, an increase of 12.5% from 2010. The ratio of operating expenses to operating revenues was 90.2%, which slightly increased when compared to 2010.

The following table sets forth a breakdown of the operating expenses of the Group in 2010 and 2011 and their respective rates of change:

(RMB in millions, except percentage data)	For the year ended 31 December		Rate of Change
	2011	2010 (restated)	
Depreciation and amortisation	51,224	52,215	(1.9%)
Network operations and support expenses	52,912	47,432	11.6%
Selling, general and administrative expenses	48,741	42,130	15.7%
Personnel expenses	39,167	35,529	10.2%
Other operating expenses	28,868	19,106	51.1%
Total operating expenses	220,912	196,412	12.5%

Depreciation and Amortisation

In 2011, depreciation and amortisation was RMB51,224 million, a decrease of 1.9% from RMB52,215 million in 2010, accounting for 20.9% of our operating revenues. The decline was due to the continuous prudent control of capital expenditure by the Group.

Network Operations and Support Expenses

In 2011, network operations and support expenses were RMB52,912 million, an increase of 11.6% from RMB47,432 million in 2010, accounting for 21.6% of our operating revenues. The increase was mainly attributable to the increase in CDMA network capacity lease fee. The CDMA network capacity lease fee in 2011 amounted to RMB19,011 million, an increase of 42.7% from 2010.

Selling, General and Administrative Expenses

In 2011, selling, general and administrative expenses amounted to RMB48,741 million, an increase of 15.7% from RMB42,130 million in 2010, accounting for 19.9% of our operating revenues. The growth was mainly attributable to the increase in the deployment of selling resources so as to promote the scale development of mobile and broadband services, etc. In the meantime, the Group continued to implement stringent cost control measures on general and administrative expenses. Compared to the same period of last year, general and administrative expenses increased by 1.2%, which was lower than the rate of increase in revenues of the same period.

Personnel Expenses

In 2011, personnel expenses were RMB39,167 million, an increase of 10.2% from RMB35,529 million in 2010, accounting for 16.0% of our operating revenues. The increase in personnel expenses was mainly due to the appropriate increased efforts in motivating the talents and frontline employees.

Other Operating Expenses

In 2011, other operating expenses were RMB28,868 million, an increase of 51.1% from RMB19,106 million in 2010, accounting for 11.8% of our operating revenues. The increase was mainly attributable to the increase in the cost of mobile terminal equipment sold. The cost of mobile terminal equipment sold amounted to RMB12,866 million in 2011, an increase of 159.2% from 2010.

Net Finance Costs

In 2011, the Group's net finance costs were RMB2,254 million, a decline of 37.4% from RMB3,600 million in 2010. Net interest expenses fell by RMB1,085 million. The decrease was mainly attributable to the significant decline of the Group's interest-bearing debt. Net exchange gains were RMB51 million in 2011, while net exchange losses were RMB92 million in 2010. The change in net exchange gain/loss was mainly attributable to the appreciation of the RMB against the Japanese Yen.

Profitability Level

Income Tax

The Group's statutory income tax rate is 25%. In 2011, the Group's income tax expenses were RMB5,416 million with the effective income tax rate of 24.6%. The effective income tax rate of the Group was lower than the statutory income tax rate

mainly because of the preferential income tax rate enjoyed by our branches located in special economic zones of China and some subsidiaries.

Profit Attributable To Equity Holders of the Company

In 2011, profit attributable to equity holders of the Company was RMB16,502 million, an increase of 7.5% from RMB15,347 million in 2010. Excluding the amortisation of upfront connection fees, profit attributable to equity holders of the Company was RMB16,404 million, an increase of 10.5% from RMB14,850 million in 2010.

Capital Expenditure and Cash Flows

Capital Expenditure

In 2011, in order to promote the development and reinforce the leading edge of broadband services, the Group continued to increase the investment in broadband network construction, and increase the penetration rate of fibre access and broadband access speed. In the meantime, the Group emphasized investment effectiveness, optimised investment structure, and effectively controlled investments in wireline voice services and infrastructure, etc. In 2011, capital expenditure of the Group was RMB49,551 million, an increase of 15.1% from RMB43,037 million in 2010.

Cash Flows

In 2011, net increase in cash and cash equivalents for the Group was RMB1,649 million, while the net decrease in cash and cash equivalents was RMB8,934 million in 2010.

The following table sets forth the cash flow position of the Group in 2010 and 2011:

(RMB millions)	For the year ended 31 December	
	2011	2010
Net cash flow from operating activities	73,006	75,571
Net cash used in investing activities	(43,637)	(45,734)
Net cash used in financing activities	(27,720)	(38,771)
Net increase/(decrease) in cash and cash equivalents	1,649	(8,934)

In 2011, the net cash inflow from operating activities was RMB73,006 million, a decrease of RMB2,565 million from RMB75,571 million in 2010.

In 2011, the net cash outflow for investing activities was RMB43,637 million, a decrease of RMB2,097 million from RMB45,734 million in 2010, mainly resulting from an increase

in proceeds from the disposal of assets compared to 2010, and the repayment of CDMA business acquisition, amounting to RMB5,374 million in 2010.

In 2011, the net cash outflow for financing activities was RMB27,720 million, a decrease of RMB11,051 million from RMB38,771 million in 2010. The decrease in net cash outflow was mainly due to the decrease in the Group's repayment of the bank loans and other loans when compared to 2010.

Working Capital

At the end of 2011, the Group's working capital (total current assets minus total current liabilities) deficit was RMB67,682 million, a reduction of deficit of RMB3,996 million from RMB71,678 million in 2010. As at 31 December 2011, the Group's unutilised committed credit facilities was RMB118,970 million (2010: RMB98,576 million). At the end of 2011, the

Group's cash and cash equivalents amounted to RMB27,372 million, amongst which cash and cash equivalents denominated in Renminbi accounted for 94.4% (2010: 91.2%).

Assets and Liabilities

In 2011, the Group continued to maintain a solid capital structure. By the end of 2011, the total assets of the Group fell to RMB419,115 million from RMB420,529 million at the end of 2010, while total indebtedness decreased to RMB52,103 million from RMB73,576 million in 2010. The ratio of the Group's total indebtedness to total assets fell from 17.5% at the end of 2010 to 12.4% at the end of 2011.

Indebtedness

The indebtedness analysis of the Group as of the end of 2010 and 2011 is as follows:

(RMB millions)	For the year ended 31 December	
	2011	2010
Short-term debt	9,187	20,675
Long-term debt maturing within one year	11,766	10,352
Long-term debt (excluding current portion)	31,150	42,549
Total debt	52,103	73,576

By the end of 2011, the total indebtedness of the Group was RMB52,103 million, a decrease of RMB21,473 million from the end of 2010. The main reason for the decrease was the Group's repayment of a portion of bank loans and other loans. Of the total indebtedness of the Group, the Company's loans in Renminbi, US Dollars, Japanese Yen and Euro accounted for 94.7% (2010: 96.0%), 1.3% (2010: 1.0%), 3.1% (2010: 2.2%), and 0.9% (2010: 0.8%), respectively. 96.3% (2010: 98.5%) of this indebtedness are loans with fixed interest rates, while the remainders are loans with floating interest rates.

As of 31 December 2011, the Group did not pledge any assets as collateral for debt (2010: Nil).

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.

Contractual Obligations

(RMB millions)	Total	Payable in				Thereafter
		1 January 2012- 31 December 2012	1 January 2013- 31 December 2013	1 January 2014- 31 December 2014	1 January 2015- 31 December 2015	
Short-term debt	9,391	9,391	–	–	–	–
Long-term debt	47,087	13,513	11,592	21,019	96	867
Operating lease commitments	21,103	18,182	782	600	413	1,126
Capital commitments	6,369	6,369	–	–	–	–
Total contractual obligations	83,950	47,455	12,374	21,619	509	1,993

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