

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

Summary

In 2012, the Group further deepened the strategic transformation, in alignment with the main theme of "promoting scale development through dual-leadership in innovation and service", adhered to the scale operation and data traffic operation, endeavoured to enhance our four core capabilities, including innovation, service, centralised efficient management and operation. The overall operating condition of the Company was healthy, with the growth of revenue beyond expectation, and the business structure continued to be optimised. The Group's operating revenues in 2012 were RMB283,073 million, an increase of 15.5%¹ from 2011; operating expenses were RMB261,887 million, an increase of 18.5% from 2011; profit attributable to equity holders of the Company was RMB14,925 million and basic earnings per share were RMB0.18; EBITDA² was RMB96,387 million and the EBITDA margin³ was 37.3%.

Operating Revenues

In 2012, the Group firmly seized the development opportunities, its full services developed well, the mobile service revenues grew rapidly, the wireline service revenues recovered, the operating revenues achieved a double-digit growth, and the revenue structure continued to be optimised. Operating revenues in 2012 were RMB283,073 million, an increase of 15.5% from 2011. Of this, the total mobile revenue was RMB117,826 million, an increase of 42.5% from 2011. The wireline services revenues were RMB165,247 million, an increase of 1.8% from 2011. The aggregate of mobile service revenues⁴, wireline broadband revenue, wireline value-added services and integrated information application services revenue accounted for 67.2% of the total operating revenues, an increase of 2.4 percentage points from 2011.

¹ In 2012, the Group acquired the digital trunking business from Besttone Holding. As the transaction was recognised as a combination of entities under common control, the comparative figures of prior years have been restated accordingly. Please refer to note 1 to the audited financial statements in this annual report for details.

² EBITDA was calculated from operating revenues 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.

³ EBITDA margin was calculated from EBITDA divided by operating revenues excluding the revenue from mobile terminal sales.

⁴ Mobile service revenue represents total mobile revenue minus other mobile revenue. Of this, in 2012, other mobile revenue amounted to RMB25,023 million.

The following table sets forth a breakdown of the operating revenues of the Group for 2011 and 2012, together with their respective rates of change:

| | For the year ended 31 December | | |
|---|-----------------------------------|---------|-------------------------------|
| | 2012 | 2011 | Rates of change (restated) |
| (RMB millions, except percentage data) | | | |
| Wireline voice | 43,335 | 49,764 | (12.9%) |
| Mobile voice | 49,166 | 38,628 | 27.3% |
| Internet | 87,660 | 74,992 | 16.9% |
| Value-added services | 31,104 | 25,554 | 21.7% |
| Integrated information application services | 23,174 | 20,473 | 13.2% |
| Managed data and leased line | 15,710 | 14,273 | 10.1% |
| Others | 32,924 | 21,286 | 54.7% |
| Upfront connection fees | — | 98 | (100.0%) |
| Total operating revenues | 283,073 | 245,068 | 15.5% |

Wireline Voice

Through measures of convergent packages and wireline monthly packages, the Group slowed down the loss of wireline voice revenue. The negative effect of wireline voice significantly reduced and its operating risk was further alleviated. In 2012, revenue from wireline voice services was RMB43,335 million, a decrease of 12.9% from RMB49,764 million in 2011, accounting for 15.3% of our operating revenues.

Mobile Voice

In 2012, the Group rapidly expanded the scale of mobile subscribers, and the mobile service has maintained rapid growth. Revenue from mobile voice services was RMB49,166 million, an increase of 27.3% from RMB38,628 million in 2011, accounting for 17.4% of our operating revenues. In 2012, the net increase in the number of mobile subscribers was 34.15 million, reaching 161 million.

Internet

In 2012, revenue from Internet access services was RMB87,660 million, an increase of 16.9% from RMB74,992 million in 2011, accounting for 31.0% of our operating revenues. On one hand, the Group fostered the rapid growth of broadband service through deeply accelerating the "Broadband China • Fibre Cities" project and the promotion of "Lightening Fibre Residential Areas". At the end of 2012, the number of wireline broadband subscribers reached 90.12 million, the wireline broadband revenue of the Group was RMB66,738 million, an increase of 9.8% from 2011. On the other hand, the Group fully leveraged the advantage in 3G network and services, and persisted in data traffic operation. Revenue from mobile Internet access services was RMB19,880 million, an increase of 49.5% from 2011.

Value-Added Services

In 2012, revenue from value-added services was RMB31,104 million, an increase of 21.7% from RMB25,554 million in 2011, accounting for 11.0% of our operating revenues. The increase in revenue was mainly attributable to the rapid growth of mobile value-added services, such as SMS, MMS, iMusic and caller ID services, following the rapid growth in the number of mobile subscribers. Revenue from mobile value-added services was RMB16,848 million, an increase of 39.6% from 2011. As the rapid growth of Internet Data Center and iTV contents and applications services compensated the decline in PAS services, the revenue from wireline value-added services increased by 5.7% from 2011.

Integrated Information Application Services

In 2012, revenue from integrated information application services was RMB23,174 million, an increase of 13.2% from RMB20,473 million in 2011, accounting for 8.2% of our operating revenues. The increase in revenue was mainly due to the rapid development of the IT services and applications services as well as "Best Tone" type of information services. Revenue from mobile integrated information application services was RMB6,749 million, an increase of 61.8% from 2011.

Managed Data and Leased Line

In 2012, revenue from managed data and leased line services was RMB15,710 million, an increase of 10.1% from RMB14,273 million in 2011, accounting for 5.5% of our operating revenues. As the demand from government and enterprise customers for informatisation continues to increase, the revenue growth from domestic leased circuits services, IP-VPN services and leased optic fibre channel have increased quite rapidly. Revenue from mobile managed data and leased line services was RMB160 million.

Others

In 2012, revenue from other services was RMB32,924 million, an increase of 54.7% from RMB21,286 million in 2011, accounting for 11.6% of our operating revenues. With the growth of the scale of mobile subscribers, the Group further increased the effort in the procurement and sales of mobile terminal equipment, especially 3G smartphones. Revenue from sales of mobile terminal equipment was RMB24,757 million, an increase of 77.7% from 2011.

Operating Expenses

Taking advantage of the opportunities of the launch of iPhone, the Group increased cost input with rational resource centralisation, further promoted the breakthrough into the high-end market and the sustainable development in the future. In 2012, the operating expenses of the Group were RMB261,887 million, an increase of 18.5% from 2011. The ratio of operating expenses to operating revenues was 92.5%, which increased by 2.3 percentage points from 2011.

The following table sets forth a breakdown of the operating expenses of the Group in 2011 and 2012 and their respective rates of change:

| (RMB millions, except percentage data) | For the year ended 31 December | | |
|--|-----------------------------------|---------|-------------------------------|
| | 2012 | 2011 | Rates of change (restated) |
| Depreciation and amortisation | 49,655 | 51,233 | (3.1%) |
| Network operations and support expenses | 66,003 | 52,925 | 24.7% |
| Selling, general and administrative expenses | 63,076 | 48,746 | 29.4% |
| Personnel expenses | 42,812 | 39,167 | 9.3% |
| Other operating expenses | 40,341 | 28,870 | 39.7% |
| Total operating expenses | 261,887 | 220,941 | 18.5% |

Depreciation and Amortisation

In 2012, depreciation and amortisation was RMB49,655 million, a decrease of 3.1% from RMB51,233 million in 2011, accounting for 17.5% 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 2012, network operations and support expenses were RMB66,003 million, an increase of 24.7% from RMB52,925 million in 2011, accounting for 23.3% of our operating revenues. The increase was mainly attributable to the corresponding increase in CDMA network capacity lease fee and operating and maintenance expenses along with the business development. The CDMA network capacity lease fee in 2012 amounted to RMB25,546 million, an increase of 34.4% from 2011.

Selling, General and Administrative Expenses

In 2012, selling, general and administrative expenses amounted to RMB63,076 million, an increase of 29.4% from RMB48,746 million in 2011, accounting for 22.3% of our operating revenues. The growth was mainly because the Group seized the opportunity of launching iPhone, expanded the high-end subscriber market and appropriately increased the marketing initiatives.

Advertising and promotion expenses amounted to RMB34,901 million, an increase of 26.9% from 2011. Commission and service expenses for third parties amounted to RMB19,537 million, an increase of 36.0% from 2011. In 2012, faced with the intensified competition of mobile services, the Group increased the cost input of terminal equipment offered to customers for free or at a nominal price in advertising and promotion expenses. The cost of terminal equipment offered to customers for free or at a nominal price amounted to RMB21,754 million in 2012, an increase of 39.1% from 2011. At the same time, the Group continued its prudent control on general and administrative expenses. Compared to the same period of last year, general and administrative expenses increased by 15.0%, which was slightly lower than the rate of increase in revenues for the same period.

Personnel Expenses

In 2012, personnel expenses were RMB42,812 million, an increase of 9.3% from RMB39,167 million in 2011, accounting for 15.1% of our operating revenues. The ratio of personnel expenses to operating revenues decreased by 0.9 percentage points when compared to 2011. The Group strengthened the control of personnel expenses, and the rate of increase in personnel expenses was lower than the increase in revenues for the same period. In the meantime, the Group appropriately increased the incentives for talent and frontline staff.

Other Operating Expenses

In 2012, other operating expenses were RMB40,341 million, an increase of 39.7% from RMB28,870 million in 2011, accounting for 14.3% 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 RMB23,099 million, an increase of 79.5% from 2011.

Net Finance Costs

In 2012, the Group's net finance costs were RMB1,564 million, a decline of 30.6% from RMB2,254 million in 2011. Net interest expenses decreased by RMB556 million. The decrease was mainly because the Group repaid part of interest-bearing debt. Net exchange losses were RMB1 million in 2012, while net exchange gains were RMB51 million in 2011. The change in net exchange gain/loss was mainly attributable to the depreciation of the RMB against the Euro.

Profitability Level

Income Tax

The Group's statutory income tax rate is 25%. In 2012, the Group's income tax expenses were RMB4,753 million with the effective income tax rate of 24.0%. The difference of effective income tax rate and the statutory income tax rate was mainly due to the preferential income tax rate, which was lower than the statutory income tax rate, enjoyed by some of our subsidiaries, and branches with operations in the western region of China.

Profit Attributable To Equity Holders of the Company

In 2012, profit attributable to equity holders of the Company was RMB14,925 million, a decrease of 9.5% from RMB16,500 million in 2011. The decrease was mainly because the Group appropriately increased cost inputs so as to firmly seize the opportunity of scale development.

Acquisition of Mobile Network
 In order to unify mobile service operation with network as a whole and enhance future profitability of the Company, the Company and its controlling shareholder, China Telecommunications Corporation entered into the Acquisition Agreement on 22 August 2012, pursuant to which the Company has agreed to purchase certain CDMA network assets and associated liabilities, which were held by China Telecommunications Corporation through the network branches located in 30 provinces, municipalities and autonomous regions in the PRC ("Mobile Network Acquisition"). The Mobile Network Acquisition was completed on 31 December 2012. Pursuant to the Acquisition Agreement, the final consideration was approximately RMB87,210 million, of which the assets amounting to approximately RMB119,715 million and associated liability amounting to approximately RMB32,505 million. The first instalment of RMB25,500 million of the final consideration was paid in January 2013, and the deferred consideration amounting to approximately

RMB61,710 million will be payable on or before the fifth anniversary of the completion date of the acquisition. The interest rate for the first year is 4.83%. As the transaction was recognised as an assets acquisition, the respective assets and associated liabilities were recognised at purchase price on the completion date of the acquisition⁵.

Capital Expenditure and Cash Flows

Capital Expenditure

In 2012, in order to reinforce the advantages of broadband networks and enhance the core-competitiveness of the network, the Group continued to increase the investment in broadband network construction. At the same time, the Group emphasised to optimise investment structure, specially guaranteed the investment in high growth services, and strictly controlled investment in traditional wireline services. In 2012, capital expenditure of the Group was RMB53,731 million, an increase of 8.4% from RMB49,551 million in 2011.

Cash Flows

In 2012, net increase in cash and cash equivalents for the Group was RMB2,613 million, while the net increase in cash and cash equivalents was RMB1,649 million in 2011.

The following table sets forth the cash flow position of the Group in 2011 and 2012:

| (RMB millions) | For the year ended 31 December | |
|---|--------------------------------|--------------------|
| | 2012 | 2011 (restated) |
| Net cash flow from operating activities | 70,667 | 73,009 |
| Net cash used in investing activities | (48,252) | (43,637) |
| Net cash used in financing activities | (19,802) | (27,723) |
| Net increase in cash and cash equivalents | 2,613 | 1,649 |

⁵ Please refer to note 2 to the audited financial statements in this annual report for details.

In 2012, the net cash inflow from operating activities was RMB70,667 million, a decrease of RMB2,342 million from RMB73,009 million in 2011.

In 2012, the net cash outflow for investing activities was RMB48,252 million, an increase of RMB4,615 million from RMB43,637 million in 2011, mainly resulting from an increase in capital expenditure compared to 2011.

In 2012, the net cash outflow for financing activities was RMB19,802 million, a decrease of RMB7,921 million from RMB27,723 million in 2011. 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 2011.

Working Capital

At the end of 2012, the Group's working capital (total current assets minus total current liabilities) deficit was RMB128,251 million, an increase of deficit of RMB60,570 million from RMB67,681 million in 2011, mainly resulting from increased payables amounting to RMB58,005 million from Mobile Network Acquisition (including

the first installment of RMB25,500 million of the final consideration and associated liabilities of RMB32,505 million). As at 31 December 2012, the Group's unutilised committed credit facilities was RMB163,130 million (2011: RMB118,970 million). At the end of 2012, the Group's cash and cash equivalents amounted to RMB29,982 million, amongst which cash and cash equivalents denominated in Renminbi accounted for 97.6% (2011: 94.4%).

Assets and Liabilities

In 2012, the Group continued to maintain a solid financial position after the Mobile Network Acquisition. By the end of 2012, the total assets of the Group increased to RMB545,072 million from RMB419,151 million at the end of 2011, while total indebtedness increased to RMB99,808 million from RMB52,103 million in 2011. The ratio of the Group's total indebtedness to total assets increased to 18.3% at the end of 2012 from 12.4% at the end of 2011, mainly resulting from the deferred consideration of the Mobile Network Acquisition.

Indebtedness

The indebtedness analysis of the Group as of the end of 2011 and 2012 is as follows:

| | For the year ended 31 December | |
|---|--------------------------------|--------|
| | 2012 | 2011 |
| (RMB millions) | | |
| Short-term debt | 6,523 | 9,187 |
| Long-term debt maturing within one year | 10,212 | 11,766 |
| Long-term debt and payable (excluding current portion) | 83,070 | 31,150 |
| Finance lease obligations | 3 | — |
| Total debt | 99,808 | 52,103 |

By the end of 2012, the total indebtedness of the Group was RMB99,808 million, an increase of RMB47,705 million from the end of 2011. The main reason for the increase was the deferred consideration of the Mobile Network Acquisition. Of the total indebtedness of the Group, the Group's loans in Renminbi, US Dollars, Japanese Yen and Euro accounted for 98.9% (2011: 94.7%), 0.6% (2011: 1.3%), 0% (2011: 3.1%), and 0.5% (2011: 0.9%), respectively. 37.5% (2011: 96.3%) of this indebtedness are loans with

fixed interest rates, while the remainders are loans with floating interest rates.

As at 31 December 2012, the Group did not pledge any assets as collateral for debt (2011: 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) | Payable in | | | | | | |
|-------------------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|------------|-------|
| | 1 January 2013 – 31 December | 1 January 2014 – 31 December | 1 January 2015 – 31 December | 1 January 2016 – 31 December | 1 January 2017 – 31 December | Thereafter | |
| | Total | 2013 | 2014 | 2015 | 2016 | 2017 | |
| | (RMB millions) | | | | | | |
| Short-term debt | 6,652 | 6,652 | – | – | – | – | – |
| Long-term debt and payable | 110,705 | 14,571 | 23,997 | 3,075 | 3,074 | 65,292 | 696 |
| Finance lease obligation | 3 | – | 2 | 1 | – | – | – |
| Operating lease commitments | 6,919 | 2,119 | 1,195 | 877 | 686 | 553 | 1,489 |
| Capital commitments | 7,103 | 7,103 | – | – | – | – | – |
| Total contractual obligations | 131,382 | 30,445 | 25,194 | 3,953 | 3,760 | 65,845 | 2,185 |

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



Smartphone Users

> 50,000,000

e-Surfing Apps

> 180,000

Yes We Can
GRASP
the Golden Opportunities

Rapidly
Increasing Use of
Smartphones and
Mobile Internet
Applications

