

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

Summary

In 2013, the Group firmly adhered to the main theme of “promoting dual enhancement in scale and profitability through dual-leadership in innovation and service”, and further promoted the strategic transformation of “De-telecom”, “Market Orientation and Differentiation” and “Three New Roles”. The overall operating condition of the Company was stable and healthy. With the double-digit growth of both operating revenues and net profit, the business structure continued to be optimised and competitiveness continued to be enhanced. The Group's operating revenues in 2013 were RMB321,584 million, an increase of 13.6%¹ from 2012; operating expenses were RMB294,116 million, an increase of 12.3% from 2012; profit attributable to equity holders of the Company was RMB17,545 million, an increase of 17.4% from 2012; basic earnings per share were RMB0.22; EBITDA² was RMB96,551 million and the EBITDA margin³ was 34.0%.

Operating Revenues

In 2013, the Group continued to firmly seize the development opportunities, with the steady growth in its subscribers' scale, the operating revenues continued to maintain at a high double-digit growth rate, the Group's market share steadily increased and the revenue structure continued to be optimised. Operating revenues in 2013 were RMB321,584 million, an increase of 13.6% from 2012. Of this, the total mobile revenue was RMB151,186 million, an increase of 28.3% from 2012. The wireline services revenues were RMB170,398 million, an increase of 3.1% from 2012. The aggregate of mobile service revenue⁴, wireline broadband revenue, wireline value-added services and integrated information application services revenue accounted for 68.1% of the total operating revenues, an increase of 0.9 percentage points from 2012.

1 In 2013, the Group acquired China Telecom (Europe) Limited. 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 plus depreciation and amortisation. 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 such as the Company. Although EBITDA has been widely applied in the global telecommunications industry as a benchmark to reflect operating performance, debt raising ability 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 2013, other mobile revenue amounted to RMB37,435 million.

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The following table sets forth a breakdown of the operating revenues of the Group for 2012 and 2013, together with their respective rates of change:

<i>(RMB millions, except percentage data)</i>	For the year ended 31 December		Rates of change
	2013	2012 (restated)	
Wireline voice	38,633	43,369	(10.9%)
Mobile voice	58,217	49,166	18.4%
Internet	99,394	87,662	13.4%
Value-added services	36,230	31,137	16.4%
Integrated information application services	25,233	23,181	8.9%
Telecommunications network resource services and lease of network equipment	17,586	15,737	11.7%
Others	46,291	32,924	40.6%
Total operating revenues	321,584	283,176	13.6%

Wireline Voice

Through measures of convergent packages and wireline monthly packages, the Group slowed down the loss of wireline voice revenue and the negative effect of wireline voice was further reduced. In 2013, revenue from wireline voice services was RMB38,633 million, a decrease of 10.9% from RMB43,369 million in 2012, accounting for 12.0% of our operating revenues.

Mobile Voice

In 2013, the Group continued to strengthen its effort on expanding the scale of mobile subscribers, and the mobile service has maintained rapid growth. In 2013, the net increase in the number of mobile subscribers was 24.96 million, reaching a total of 186 million. Revenue from mobile voice services was RMB58,217 million, an increase of 18.4% from RMB49,166 million in 2012, accounting for 18.1% of our operating revenues.

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Internet

In 2013, revenue from Internet access services was RMB99,394 million, an increase of 13.4% from RMB87,662 million in 2012, accounting for 30.9% of our operating revenues. On one hand, the Group adopted the development strategy of “Emphasising quality on the high-end, significantly improving network speed for the mainstream market, and improving market share on the low-end”, and continued to deepen the implementation of the “Lightening Fibre Residential Areas” initiative, formulated the “Broadband Excellence” program and realised a quantum leap of broadband service speed, and promote the rapid development of broadband services. At the end of 2013, the number of wireline broadband subscribers reached 100 million, the wireline broadband revenue of the Group was RMB70,821 million, an increase of 6.1% from 2012. On the other hand, the Group fully leveraged its advantage in 3G network and services, and persisted in data traffic operation. Revenue from mobile Internet access services was RMB27,962 million, an increase of 40.7% from 2012.

Value-Added Services

In 2013, revenue from value-added services was RMB36,230 million, an increase of 16.4% from RMB31,137 million in 2012, accounting for 11.3% of our operating revenues. With the growth in the number of mobile subscribers, mobile value-added services such as SMS, MMS, and caller ID services developed rapidly. Revenue from mobile value-added services was RMB19,748 million, an increase of 17.2% from 2012. Due to the rapid growth of the Internet Data Centre services and iTV services, the revenue from wireline value-added services increased by 15.3% from 2012.

Integrated Information Application Services

In 2013, revenue from integrated information application services was RMB25,233 million, an increase of 8.9% from RMB23,181 million in 2012, accounting for 7.8% of our operating revenues. The increase in revenue was mainly due to the rapid development of Information and Communication Technology services. Revenue from mobile integrated information application services was RMB7,441 million, an increase of 10.3% from 2012.

Telecommunications Network Resource Services and Lease of Network Equipment

In 2013, revenue from telecommunications network resource services and lease of network equipment was RMB17,586 million, an increase of 11.7% from RMB15,737 million in 2012, accounting for 5.5% of our operating revenues. As the demand from government and enterprise customers for informatisation continued to increase, the revenue growth from domestic and international circuits services and lease of network equipment has increased quite rapidly. Revenue from lease of mobile network equipment was RMB383 million.

Others

In 2013, revenue from other services was RMB46,291 million, an increase of 40.6% from RMB32,924 million in 2012, accounting for 14.4% of our operating revenues. With the growth in the scale of mobile subscribers, the Group further increased the effort in the efficiently-centralised procurement and sales of mobile terminal equipment, especially “star” smartphones at different price levels. Revenue from sales of mobile terminal equipment was RMB37,435 million, an increase of 51.2% from 2012.

Operating Expenses

While reasonably coordinating our resources, the Group further strengthened our cost control efforts, and promoted profitable scale development of the enterprise. In 2013, operating expenses of the Group were RMB294,116 million, an increase of 12.3% compared with 2012, and the rate of growth of operating expenses was lower than the revenue growth rate. Operating expenses accounted for 91.5% of our operating revenues, a decrease of 1.0 percentage point from 2012.

The following table sets forth a breakdown of the operating expenses of the Group in 2012 and 2013 and their respective rates of change:

<i>(RMB millions, except percentage data)</i>	For the year ended 31 December		Rates of change
	2013	2012 (restated)	
Depreciation and amortisation	69,083	49,666	39.1%
Network operations and support expenses	53,102	65,979	(19.5%)
Selling, general and administrative expenses	70,448	63,099	11.6%
Personnel expenses	46,723	42,857	9.0%
Other operating expenses	54,760	40,367	35.7%
Total operating expenses	294,116	261,968	12.3%

Depreciation and Amortisation

In 2013, depreciation and amortisation was RMB69,083 million, an increase of 39.1% from RMB49,666 million in 2012, accounting for 21.5% of our operating revenues. The increase in depreciation and amortisation was mainly due to the increase in depreciation as a result of the acquisition of mobile network assets at the end of 2012.

Network Operations and Support Expenses

In 2013, network operations and support expenses were RMB53,102 million, a decrease of 19.5% from RMB65,979 million in 2012, accounting for 16.5% of our operating revenues. The decline was mainly due to the fact that the Group no longer needs to pay to China Telecommunications Corporation the CDMA network capacity lease fee after the completion of the acquisition of mobile network assets.

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Selling, General and Administrative Expenses

In 2013, selling, general and administrative expenses amounted to RMB70,448 million, an increase of 11.6% from RMB63,099 million in 2012, accounting for 21.9% of our operating revenues. The growth was mainly attributable to the Group's increased efforts to expand social channels and appropriately increased marketing initiatives. Commission and service expenses for third parties amounted to RMB25,519 million, an increase of 30.6% from 2012. Advertising and promotion expenses amounted to RMB36,490 million, an increase of 4.5% from 2012. The cost of terminal equipment offered to customers for free or at a nominal price amounted to RMB22,795 million in 2013, an increase of 4.8% from 2012. At the same time, the Group continued its prudent control on general and administrative expenses. Compared to last year, general and administrative expenses decreased by 2.5%.

Personnel Expenses

In 2013, personnel expenses were RMB46,723 million, an increase of 9.0% from RMB42,857 million in 2012, accounting for 14.6% of our operating revenues. The ratio of personnel expenses to operating revenues decreased by 0.5 percentage points when compared to 2012. While the Group strengthened the control on personnel expenses, it appropriately increased the remuneration for frontline staff to increase their passion and promote business development. For details of the number of employees, remuneration policies and training schemes, please refer to the Human Resources Development Report in this annual report.

Other Operating Expenses

In 2013, other operating expenses were RMB54,760 million, an increase of 35.7% from RMB40,367 million in 2012, accounting for 17.0% 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 RMB35,227 million, an increase of 52.5% from 2012.

Net Finance Costs

In 2013, the Group's net finance costs were RMB5,153 million, an increase of 229.9% from RMB1,562 million in 2012. The increase was mainly due to the interest expenses arising from the deferred consideration of the mobile network assets acquisition and new short-term loans. Net exchange losses were RMB3 million in 2013.

Profitability Level

Income Tax

The Group's statutory income tax rate is 25%. In 2013, the Group's income tax expenses were RMB5,422 million with the effective income tax rate of 23.5%. The difference between the 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 its branches with operations in the western region of China and some of its subsidiaries.

Profit Attributable To Equity Holders of the Company

In 2013, profit attributable to equity holders of the Company was RMB17,545 million, an increase of 17.4% from RMB14,949 million in 2012.

Capital Expenditure and Cash Flows

Capital Expenditure

In 2013, in order to seize the development opportunities of mobile services, reinforce the advantages of broadband networks and enhance the core-competitiveness of the network, the Group increased its capital expenditure but at the same time emphasised the optimisation of its investment

structure, with particular emphasis on investment in high growth services, while investment in traditional wireline services were strictly controlled. In 2013, capital expenditure of the Group was RMB79,992 million, an increase of 48.8% from RMB53,748 million in 2012. The increase in capital expenditure was mainly attributable to the Group's obligation to invest into the mobile network after completion of the mobile network assets acquisition at the end of 2012.

Cash Flows

In 2013, net decrease in cash and cash equivalents for the Group was RMB13,960 million, while the net increase in cash and cash equivalents was RMB2,625 million in 2012.

The following table sets forth the cash flow position of the Group in 2012 and 2013:

<i>(RMB millions)</i>	For the year ended 31 December	
	2013	2012 (restated)
Net cash flow from operating activities	88,351	70,722
Net cash used in investing activities	(107,948)	(48,295)
Net cash from/(used in) financing activities	5,637	(19,802)
Net (decrease)/increase in cash and cash equivalents	(13,960)	2,625

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In 2013, the net cash inflow from operating activities was RMB88,351 million, an increase of RMB17,629 million from RMB70,722 million in 2012. The increase was mainly due to the increase in operating revenues and that no CDMA network capacity lease fee was payable after the acquisition of mobile network assets.

In 2013, the net cash outflow used in investing activities was RMB107,948 million, an increase of RMB59,653 million from RMB48,295 million in 2012, mainly resulting from an increase in capital expenditures compared to 2012 and the payment of part of the consideration for the acquisition of mobile network assets.

In 2013, the net cash inflow from financing activities was RMB5,637 million. In 2012, the net cash outflow used in financing activities was RMB19,802 million. The reason of the fluctuation was mainly due to the increase in short-term loans.

Working Capital

The Group consistently upheld prudent financial principles and strict fund management policies. At the end of 2013, the Group's working capital (total current assets minus total current liabilities) deficit

was RMB147,315 million, an increase in deficit of RMB19,080 million from RMB128,235 million in 2012. The increase in deficit was mainly because medium-term notes amounting to RMB20,000 million will become mature in 2014, thus reclassified from non-current liabilities to current liabilities. As at 31 December 2013, the Group's unutilised credit facilities was RMB157,694 million (2012: RMB163,130 million). At the end of 2013, the Group's cash and cash equivalents amounted to RMB16,070 million, amongst which cash and cash equivalents denominated in Renminbi accounted for 94.3% (2012: 97.2%).

Assets and Liabilities

In 2013, the Group continued to maintain a solid financial position. By the end of 2013, the total assets of the Group decreased to RMB543,239 million from RMB545,291 million at the end of 2012, while total indebtedness increased to RMB110,377 million from RMB99,808 million in 2012. The ratio of the Group's total indebtedness to total assets increased to 20.3% at the end of 2013 from 18.3% at the end of 2012, mainly resulting from the increase in short-term loans.

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Indebtedness

The indebtedness analysis of the Group as of the end of 2012 and 2013 is as follows:

(RMB millions)	For the year ended 31 December	
	2013	2012
Short-term debt	27,687	6,523
Long-term debt maturing within one year	20,072	10,212
Long-term debt and payable	62,617	83,070
Finance lease obligations (including current portion)	1	3
Total debt	110,377	99,808

By the end of 2013, the total indebtedness of the Group was RMB110,377 million, an increase of RMB10,569 million from the end of 2012. This is mainly due to the increase in short-term loans. Of the total indebtedness of the Group, loans denominated in Renminbi, US Dollars and Euro accounted for 99.1% (2012: 98.9%), 0.5% (2012: 0.6%), and 0.4% (2012: 0.5%), respectively. 43.3% (2012: 37.5%) of this indebtedness are loans with fixed interest rates, while the remainders are loans with floating interest rates.

As at 31 December 2013, the Group did not pledge any assets as collateral for debt (2012: 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	1 January	1 January	1 January	1 January	1 January	Thereafter
		2014 - 31 December 2014	2015 - 31 December 2015	2016 - 31 December 2016	2017 - 31 December 2017	2018 - 31 December 2018	
Short-term debt	28,279	28,279	-	-	-	-	-
Long-term debt and payable	99,135	24,874	3,951	3,950	65,660	80	620
Finance lease obligation	1	1	-	-	-	-	-
Operating lease commitments	7,573	2,236	1,516	1,087	779	611	1,344
Capital commitments	7,738	7,738	-	-	-	-	-
Total contractual obligations	142,726	63,128	5,467	5,037	66,439	691	1,964

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.