VAT Reform

Short-term pain, long-term beneficial to

SUSTAINABLE GROWTH

Summary

In 2014, in the face of a number of prominent changes in external environment, the Group firmly grasped the main theme of "reform and innovation, open cooperation, quality and efficiency enhancement", innovated in system and mechanism, refined customer acquisition strategies, accelerated the promotion of the comprehensive deepening reform and enhanced corporate value. The Group's operating revenues in 2014 were RMB324,394 million, an increase of 0.9% from 2013; service revenues[1] were RMB287,379 million, an increase of 3.1% from 2013; operating expenses were RMB295,886 million, an increase of 0.6% from 2013; profit attributable to equity holders of the Company was RMB17,680 million, an increase of 0.8% from 2013; basic earnings per share were RMB0.22; EBITDA[2] was RMB94,853 million, a decrease of 1.8% from 2013 and the EBITDA margin[3] was 33.0%.

Operating Revenues

In 2014, the Group managed to maintain a stable development condition, and the operating revenues achieved steady growth despite the impact of the value-added tax (VAT) reform and the geographical limitation on the trial of the LTE hybrid network. Operating revenues in 2014 were RMB324,394 million, an increase of 0.9% from 2013. Of this, the total mobile revenues were RMB151,611 million, an increase of 0.3% from 2013. The total wireline revenues were RMB172,783 million, an increase of 1.4% from 2013.

Service Revenues

RMB **287,379** MILLION

1 *Service revenues were calculated based on operating revenues minus sales of mobile terminals (2014: RMB31,343 million; 2013: RMB37,435 million), sales of wireline equipment (2014: RMB3,956 million; 2013: RMB3,564 million) and other non-service revenues (2014: RMB1,716 million; 2013: RMB1,734 million).*

2 *EBITDA was calculated based on 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 based on EBITDA divided by service revenues.*

The following table sets forth a breakdown of the operating revenues of the Group for 2013 and 2014, together with their respective rates of change:

	For the year ended 31 December		
(RMB millions, except percentage data)	**2014**	2013	Rates of change
Wireline voice	**33,587**	38,633	(13.1%)
Mobile voice	**54,673**	58,217	(6.1%)
Internet	**112,431**	99,394	13.1%
Value-added services	**38,419**	36,230	6.0%
Integrated information application services	**26,939**	25,233	6.8%
Telecommunications network resource services and lease of network equipment	**17,332**	17,586	(1.4%)
Others	**41,013**	46,291	(11.4%)
Total operating revenues	**324,394**	321,584	0.9%

Wireline Voice

In 2014, revenue from wireline voice services was RMB33,587 million, a decrease of 13.1% from RMB38,633 million in 2013, accounting for 10.4% of our operating revenues. Declining revenue contribution from wireline voice services effectively mitigated operating risks.

Mobile Voice

In 2014, being affected by the launch of 4G services by the peers, the VAT reform, change in our sales model and the substitution effect of mobile Internet services, revenue from mobile voice services was RMB54,673 million, a decrease of 6.1% from RMB58,217 million in 2013, accounting for 16.9% of our operating revenues.

Internet

In 2014, revenue from Internet access services was RMB112,431 million, an increase of 13.1% from RMB99,394 million in 2013, accounting for 34.7% of our operating revenues. On the basis of the customer access bandwidth upgrade, the Group enriched various informatisation applications, leveraged the integrated product, "Joy me", to create "Smart Family" portals and promoted high-bandwidth applications. At the end of 2014, the number of wireline broadband subscribers of the Group reached 107 million, and the wireline broadband revenue of the Group was RMB73,485 million, an increase of 3.8% from 2013. At the same time, the Group achieved rapid growth in the volume of and revenue from mobile data traffic, effectively driven by developing differentiated edges in products, persisting in terminal-led and application-driven approaches, innovating on the business model of data traffic operations and launching various products, such as "Liuliangbao", "Data Traffic 800" and dedicated-data traffic packages. Revenue from mobile Internet access services was RMB37,809 million, an increase of 35.2% from 2013. Of this, revenue from handset data traffic was RMB34,086 million, an increase of 48.8% from 2013.

Mobile Internet access services *revenue*

↑35.2%

Wireline value-added services *revenue*

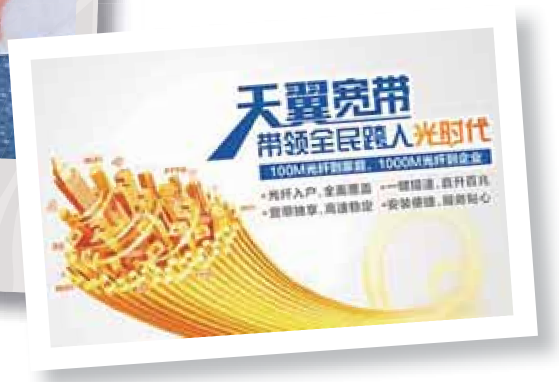
↑11.8%

Value-Added Services

In 2014, revenue from value-added services was RMB38,419 million, an increase of 6.0% from RMB36,230 million in 2013, accounting for 11.8% of our operating revenues. Of this, the revenue from wireline value-added services was RMB18,428 million, an increase of 11.8% from 2013, mainly driven by the rapid growth of the IDC and iTV services. Revenue from mobile value-added services was RMB19,991 million, an increase of 1.2% from 2013.

Integrated Information Application Services

In 2014, revenue from integrated information application services was RMB26,939 million, an increase of 6.8% from RMB25,233 million in 2013, accounting for 8.3% of our operating revenues. Of this, revenue from wireline integrated information application services was RMB19,619 million, an increase of 10.3% from 2013. The increase in revenue was mainly due to the fact that the Group focused on informatisation applications, enhanced open cooperation, accelerated the promotion of scale replication of benchmarking industry applications, which led to the rapid development of IT Services and Applications. Revenue from mobile integrated information application services was RMB7,320 million, a decrease of 1.6% from 2013.



Telecommunications Network Resource Services and Lease of Network Equipment

In 2014, revenue from telecommunications network resource services and lease of network equipment was RMB17,332 million, a decrease of 1.4% from RMB17,586 million in 2013, accounting for 5.3% of our operating revenues. The decline was mainly due to the fact that revenue from telecommunications network resource services and lease of network equipment was subject to higher VAT rate. Revenue from lease of mobile network equipment was RMB463 million.

Others

In 2014, revenue from other services was RMB41,013 million, a decrease of 11.4% from RMB46,291 million in 2013, accounting for 12.6% of our operating revenues. The decline was mainly resulted from the reduction of the centralised procurement and sales of mobile terminal equipment. Revenue from sales of mobile terminal equipment was RMB31,343 million, a decrease of 16.3% from 2013.

Operating Expenses

While continuously enhancing our coordination and management of resources, reinforcing network maintenance and optimisation and improving the capabilities of network support and service, the Group reinforced the efforts in management and control of selling expenses, enhanced the utilisation efficiency of marketing resources and promoted profitable development of the Group. In 2014, operating expenses of the Group were RMB295,886 million, an increase of 0.6% compared with 2013, and the rate of growth of operating expenses was lower than the revenue growth rate. Operating expenses accounted for 91.2% of our operating revenues, a decrease of 0.3 percentage points from 2013.

The following table sets forth a breakdown of the operating expenses of the Group in 2013 and 2014 and their respective rates of change:

	For the year ended 31 December		
(RMB millions, except percentage data)	**2014**	2013	Rates of change
Depreciation and amortisation	**66,345**	69,083	(4.0%)
Network operations and support expenses	**68,651**	53,102	29.3%
Selling, general and administrative expenses	**62,719**	70,448	(11.0%)
Personnel expenses	**50,653**	46,723	8.4%
Other operating expenses	**47,518**	54,760	(13.2%)
Total operating expenses	**295,886**	294,116	0.6%

Depreciation and Amortisation

In 2014, depreciation and amortisation was RMB66,345 million, a decrease of 4.0% from RMB69,083 million in 2013, accounting for 20.5% of our operating revenues. The decrease in depreciation and amortisation was mainly due to the saving in the amortisation of customer relationships in this year.

Network Operations and Support Expenses

In 2014, network operations and support expenses were RMB68,651 million, an increase of 29.3% from RMB53,102 million in 2013, accounting for 21.2% of our operating revenues. The growth was mainly due to the fact that the Company reasonably enhanced network maintenance quality to build competitive edges for concerted development of 3G and 4G, wireline and wireless broadband, and the increase in property rental and management fee. In addition, with the replacement of the PAS service by a more advanced mobile network, the Group disposed almost all of the PAS assets.

SG&A

↓11.0%

Selling, General and Administrative Expenses

In 2014, selling, general and administrative expenses amounted to RMB62,719 million, a decrease of 11.0% from RMB70,448 million in 2013, accounting for 19.3% of our operating revenues. The decline was mainly attributable to the fact that the Group accelerated the optimisation and innovation of its sales model, strengthened the management and control on selling expenses, especially on terminal subsidies, and improved the utilisation efficiency of marketing resources. Commission and service expenses for third parties amounted to RMB28,367 million, an increase of 11.2% from 2013. Advertising and promotion expenses amounted to RMB26,122 million, a decrease of 28.4% from 2013, of which the terminal subsidies amounted to RMB15,340 million, a decrease of 32.7% from 2013. At the same time, the Group continued to strengthen the precision management of general and administrative expenses. Compared to last year, general and administrative expenses decreased by 2.5%.

Personnel Expenses

In 2014, personnel expenses were RMB50,653 million, an increase of 8.4% from RMB46,723 million in 2013, accounting for 15.6% of our operating revenues. The growth was mainly due to that the Group raised the remuneration for frontline staff. 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 2014, other operating expenses were RMB47,518 million, a decrease of 13.2% from RMB54,760 million in 2013, accounting for 14.6% of our operating revenues. The decline was mainly attributable to the reduction of the centralised procurement and sales of mobile terminal equipment and the saving of mobile interconnection charges. The cost of mobile terminal equipment sold amounted to RMB29,982 million, a decrease of 14.9% from 2013.

Net Finance Costs

In 2014, the Group's net finance costs were RMB5,291 million, an increase of 2.7% from RMB5,153 million in 2013. The growth was mainly due to the fact that the interest rate of the deferred consideration of Mobile Network Acquisition increased from 4.83% per annum in 2013 to 6.25% per annum in 2014 (adjusted in accordance with a 5 basis points premium to the yield of the 5-year super AAA rated Medium Term Notes once a year pursuant to the agreement). Net exchange gains were RMB55 million in 2014.

Profitability Level

VAT Reform

The pilot programme of VAT reform commenced in the telecommunications industry in June 2014. Although it has an adverse impact in the short term, the Group expects that it will be beneficial for its sustainable development in the long term. The Group strived to optimise its development and sales models, implemented enhanced management over cost, procurement and vendors' tax qualifications. The relevant adverse impact has been moderated. In the future, with the continual expansion of the VAT reform to other industries, it is expected that the Group will be entitled to more input VAT credits. Together with the continuously optimising revenue structure, it will be beneficial for the enhancement of the profitability in the long term.

Income Tax

The Group's statutory income tax rate is 25%. In 2014, the Group's income tax expenses were RMB5,498 million with the effective income tax rate of 23.6%. 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 our branches with operations in the western region of China and some of our subsidiaries.

Profit Attributable To Equity Holders of the Company

In 2014, profit attributable to equity holders of the Company was RMB17,680 million, an increase of 0.8% from RMB17,545 million in 2013.

Investment in establishing China Tower Corporation Limited

In order to promote the joint construction and sharing of telecommunications infrastructure facilities and further increase the operating efficiency and corporate value, the Company, China United Network Communications Corporation Limited and China Mobile Communication Company Limited entered into a Promoters' Agreement for China Communications Facilities Services Corporation Limited in July 2014 to establish China Communications Facilities Services Corporation Limited (currently renamed as "China Tower Corporation Limited"). The registered share capital of China Tower Corporation Limited is RMB10 billion, of which RMB2,990 million was contributed by the Group, representing a shareholding percentage of 29.9%. The related subscription had been fully paid by the end of 2014.

Capital Expenditure and Cash Flows

Capital Expenditure

In 2014, the Group reasonably controlled 4G investment pace with regard to LTE hybrid network trial approval progress and adjusted the structure of capital expenditure. On the basis of the launch of the LTE hybrid network trial, the Group proactively invested in 4G auxiliary facilities and further upgraded the access bandwidth capability of the fibre network in cities to ensure the return on investment. In 2014, capital expenditure of the Group was RMB76,889 million, a decrease of 3.9% from RMB79,992 million in 2013.

Profit attributable to equity holders of the Company RMB

17,680 MILLION

Cash Flows

In 2014, net increase in cash and cash equivalents for the Group was RMB4,370 million, while the net decrease in cash and cash equivalents was RMB13,960 million in 2013.

The following table sets forth the cash flow position of the Group in 2013 and 2014:

	For the year ended 31 December	
(RMB millions)	**2014**	2013
Net cash flow from operating activities	**96,405**	88,351
Net cash used in investing activities	**(81,708)**	(107,948)
Net cash (used in)/from financing activities	**(10,327)**	5,637
Net increase/(decrease) in cash and cash equivalents	**4,370**	(13,960)

In 2014, the net cash inflow from operating activities was RMB96,405 million, an increase of RMB8,054 million from RMB88,351 million in 2013. The increase was mainly due to the increase in operating revenues and the decrease in payment of expenses related to operating activities.

In 2014, the net cash outflow used in investing activities was RMB81,708 million, a decrease of RMB26,240 million from RMB107,948 million in 2013. The decrease was mainly due to the payment of part of the consideration of Mobile Network Acquisition in 2013.

In 2014, the net cash outflow used in financing activities was RMB10,327 million. In 2013, the net cash inflow from financing activities was RMB5,637 million. The reason of the fluctuation was mainly due to the fact that the Group repaid part of short-term loans.

Working Capital

The Group consistently upheld prudent financial principles and strict fund management policies. At the end of 2014, the Group's working capital (total current assets minus total current liabilities) deficit was RMB146,782 million, a decrease in deficit of RMB533 million from RMB147,315 million in 2013. As at 31 December 2014, the Group's unutilised credit facilities were RMB130,488 million (2013: RMB157,694 million). Given the stable net cash inflow from operating activities and our sound credit record, the Group has sufficient working capital to satisfy the operation requirement. At the end of 2014, the Group's cash and cash equivalents amounted to RMB20,436 million, amongst which cash and cash equivalents denominated in Renminbi accounted for 93.1% (2013: 94.3%).

Assets and Liabilities

In 2014, the Group continued to maintain a solid financial position. At the end of 2014, the total assets of the Group increased to RMB561,274 million from RMB543,239 million at the end of 2013, while total indebtedness decreased to RMB106,552 million from RMB110,377 million at the end of 2013. The ratio of the Group's total indebtedness to total assets decreased to 19.0% at the end of 2014 from 20.3% at the end of 2013.

Indebtedness

The indebtedness analysis of the Group as of the end of 2013 and 2014 is as follows:

(RMB millions)	For the year ended 31 December 2014	2013
Short-term debt	43,976	27,687
Long-term debt maturing within one year	82	20,072
Long-term debt and deferred consideration due to China Telecommunications Corporation	62,494	62,617
Finance lease obligations (including current portion)	–	1
Total debt	106,552	110,377

By the end of 2014, the total indebtedness of the Group was RMB106,552 million, a decrease of RMB3,825 million from the end of 2013. This is mainly due to the repayment of medium-term notes amounting to RMB20 billion and part of short-term loans, and the issuance of super short-term commercial papers amounting to RMB19 billion in total. Of the total indebtedness of the Group, loans denominated in Renminbi, US Dollars and Euro accounted for 99.2% (2013: 99.1%), 0.5% (2013: 0.5%), and 0.3% (2013: 0.4%), respectively. 41.3% (2013: 43.3%) of this indebtedness are loans with fixed interest rates, while the remainders are loans with floating interest rates.

As at 31 December 2014, the Group did not pledge any assets as collateral for debt (2013: 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 2015 – 31 December 2015	1 January 2016 – 31 December 2016	1 January 2017 – 31 December 2017	1 January 2018 – 31 December 2018	1 January 2019 – 31 December 2019	Thereafter
Short-term debt	44,133	44,133	–	–	–	–	–
Long-term debt and payable	72,517	3,243	3,243	64,953	77	77	924
Operating lease commitments	9,139	2,635	1,921	1,389	1,021	678	1,495
Capital commitments	7,165	7,165	–	–	–	–	–
Total contractual obligations	132,954	57,176	5,164	66,342	1,098	755	2,419

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