Financial Review

In 2004, the Group continued to unswervingly pursue its complementary development strategies of organic and external growth, ceaselessly pursued refined management methods and sustained steady business growth. Consolidated operating revenue achieved notable growth, reaching RMB192,381 million, representing an increase of 21.3 per cent. from 2003. Consolidated EBITDA and consolidated net profit reached RMB107,221 million and RMB42,004 million, respectively, representing an increase of 16.2 per cent. and 18.1 per cent., respectively, from 2003. The Company's basic earnings per share reached RMB2.14, representing an increase of 18.2 per cent. from 2003. The Group maintained its sound capital structure and robust free cash flow, and achieved commendable financial results.

For ease of comparison, on the assumption that the existing corporate structure of the Group with 31 operating subsidiaries was in place since 1 January 2003, the Group's pro-forma combined* operating revenue reached RMB203,993 million (all monetary amounts below are expressed in RMB, unless otherwise specified), achieving a healthy growth of 13.9 per cent. EBITDA reached 113,050 million, representing an increase of 11.2 per cent. compared to that of 2003. Net profit reached 43,207 million, representing an increase of 15.3 per cent. over the 2003 net profit of 37,467 million (after adding back the deficit on revaluation of fixed assets of the newly acquired subsidiaries of 3,470 million). EBITDA margin and net profit margin maintained a relatively high level of 55.4 per cent. and 21.2 per cent., respectively.

* *For ease of comparison, unless otherwise specified, the financial information relating to the income statements for 2003 and 2004 set out in this Financial Review represents the Group's unaudited pro-forma combined ("Pro-forma Combined") data. Detailed unaudited pro-forma combined financial information, its basis of preparation and the report issued by KPMG, Certified Public Accountants, Hong Kong, are set out in pages 153 to 158 of this annual report. Financial information relating to the balance sheet and the cash flow statement set out in this Financial Review is extracted from the audited financial statements.*

Extracts from income statement

	2004 Pro-forma Combined (RMB Millions)	2003 Pro-forma Combined (RMB Millions)	change %
Operating revenue (Turnover)	**203,993**	179,068	13.9
Usage fees and monthly fees	**163,334**	149,769	9.1
New businesses revenue	**31,651**	17,936	76.5
Other operating revenue	**9,008**	11,363	(20.7)
Operating expenses	**142,345**	122,714	16.0
Leased lines	**4,199**	5,597	(25.0)
Interconnection	**12,705**	14,066	(9.7)
Depreciation	**48,059**	42,642	12.7
Personnel	**10,655**	9,721	9.6
Other operating expenses	**66,727**	50,688	31.6
Profit from operations	**61,648**	56,354	9.4
Other net income	**3,343**	2,667	25.3
Profit attributable to shareholders (Note)	**43,207**	37,467	15.3
EBITDA	**113,050**	101,663	11.2

Note: *The deficit on revaluation of fixed assets of the newly acquired subsidiaries of RMB3,470 million has been added back to the profit attributable to shareholders of 2003.*

Extracts from balance sheet

	2004 Consolidated (RMB Millions)	2003 Consolidated (RMB Millions)	Change %
Current assets	**79,909**	69,457	15.0
Non-current assets	**288,843**	237,846	21.4
Total assets	**368,752**	307,303	20.0
Current liabilities	**97,666**	78,150	25.0
Non-current liabilities	**37,682**	30,168	24.9
Total liabilities	**135,348**	108,318	25.0
Minority interests	**243**	182	33.5
Shareholders' equity	**233,161**	198,803	17.3

Extracts from cash flow statement

	2004 Consolidated (RMB Millions)	2003 Consolidated (RMB Millions)	Change %
Net cash from operating activities	**103,779**	85,534	21.3
Net cash used in investing activities	**(73,302)**	(54,292)	35.0
Net cash used in financing activities	**(24,457)**	(24,688)	(0.9)

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

Summary of Financial Results

In 2004, the Group continued to maintain its established development strategies and effectively leveraged its economies of scale and competitive advantages in its networks, businesses and services. The Group adopted effective competitive strategies and marketing plans, carried out rational investments and effective cost control measures, and continued to refine its closed-loop budget, performance and remuneration management. As a result, operating revenue realized a healthy growth of 13.9 per cent, EBITDA margin and net profit margin were also maintained at relatively high levels, and the Group also maintained a strong cash flow.

Driven by steady growth in revenue from voice business and the continued rapid growth in revenue from new businesses, operating revenue for 2004 reached 203,993 million, representing an increase of 13.9 per cent. over the previous year. To ensure steady growth in subscriber base and to maintain the competitiveness of its network, the Group suitably expanded its network capacity and performed network maintenance whilst appropriately increasing investment in sales and marketing initiatives at the same time. As such, operating expenses increased by 16.0 per cent. over the previous year and reached 142,345 million. However, the Group's refined and effective cost control measures led to a continuous decrease in average operating expenses per user per month and per minute. EBITDA was 113,050 million, representing an increase of 11.2 per cent. from the previous year. EBITDA margin was sustained at a high level of 55.4 per cent. Profit attributable to shareholders was 43,207 million, representing an increase of 15.3 per cent. from that of the previous year, while audited consolidated basic earnings per share was 2.14, representing an increase of 18.2 per cent. from the previous year.

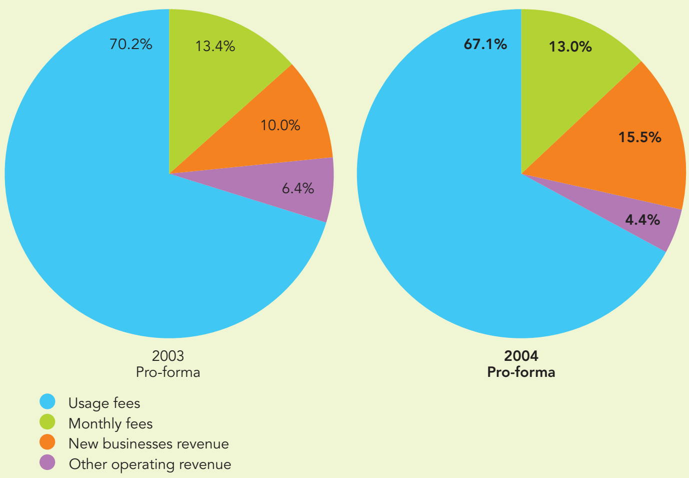
The Group sustained its strong cash flow as a result of favorable business growth, effective cost control measures, efficient capital expenditure management and the effect of economies of scale. In 2004, the Group's net cash flow from operating activities and free cash flow reached 103,779 million and 42,381 million, respectively. The Group's total debt to capitalization ratio and interest coverage multiple remained at a sound level. Standard and Poor's and Moody's each upgraded the Company's corporate credit rating, objectively reflecting further market acknowledgement of the Group's solid financial strength and stable capital structure.

In 2004, the Company successfully completed its acquisition of ten mobile telecommunications companies and other telecommunications assets in Mainland China, thereby becoming the first overseas-listed PRC telecommunications company operating in all thirty-one provinces, autonomous regions and directly-administered municipalities in Mainland China. As a result of the Group's intensive post-acquisition integration and management reforms, the newly acquired subsidiaries reported markedly improved results. These subsidiaries have all exceeded their profit forecast targets and have achieved significant improvements in management efficiency, thus contributing to the enhancement of the Group's economies of scale and growth prospects, while contributing substantially to the Group's earnings per share, and strengthening the Group's leading position in Mainland China's mobile telecommunications industry.

Operating Revenue (Turnover)

Operating revenue for 2004 was 203,993 million, representing an increase of 13.9 per cent. over the previous year. The Group continued to enhance brand building and restructuring, targeted different customer segments, further consolidated customer service and sales channels, offered personalized services, and enhanced customers' satisfaction. Revenue from the Group's voice business, representing a major portion of the Group's operating revenue, continued its strong growth trend. Revenue from usage fees and monthly fees reached 163,334 million, representing an increase of 9.1 per cent. from the previous year and accounting for 80.1 per cent. of the Group's total operating revenue. In order to react positively to the continued intense market competition, the Group adopted effective competitive strategies and marketing plans and increased utilization of its network during off-peak hours to promote increased voice usage volume in accordance with price elasticity principles. Although revenue per minute declined by 23.7 per cent. from the previous year, such strategies ensured a relatively steady ARPU and growth in total operating revenue.

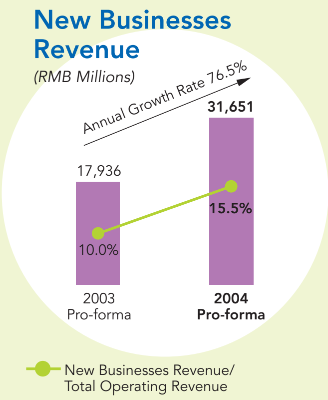
Composition of Operating Revenue

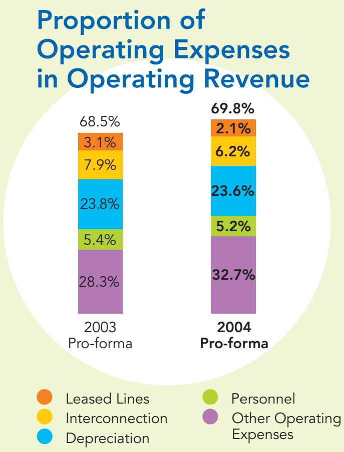


The Group strengthened the promotion of new businesses, providing customers with diversified and personalized data services and value-added services. Revenue from new businesses continued its rapid and robust growth trend and has played a greater role as a driver of the Group's overall operating revenue growth. Revenue from new businesses reached 31,651 million in 2004, representing an increase of 76.5 per cent. over the previous year, and accounted for 15.5 per cent. of the Group's operating revenue, an increase of 5.5 percentage points compared to the previous year. These revenue streams demonstrate the continuing strong growth momentum of the Group's new businesses. The Group continued to maintain a solid leading position in mobile data businesses in Mainland China. Revenue from Short Message Services (SMS) and other data businesses reached 23,103 million in 2004 and accounted for 73.0 per cent. of the Group's revenue from new businesses. While the SMS business continued to maintain its relatively high growth rate, businesses such as WAP, MMS and "Color Ring" grew rapidly and became new centers of growth among data businesses. Concurrently in 2004, the Group increased promotions to popularize the use of value-added business functions. Revenue from value-added businesses reached 8,548 million, representing an increase of 106.5 per cent. from 2003, and accounting for 27.0 per cent. of the revenue from new businesses.

Operating Expenses

Due to increased marketing efforts and the need to develop new businesses, the Group experienced an increase in operating expenses from the previous year. However, since the Group continued with cost-effective investments and refined management methods, adopted effective costs control measures and fully leveraged its economies of scale and synergies, the asset utilization rate has gradually increased, the average operating expenses per user per month, the average operating expenses per minute of usage continued to decline, and the costs structure was further improved. Operating expenses for 2004 were 142,345 million, representing an increase of 16.0 per cent. from the previous year. Average operating expenses per user per month for 2004 were 63.9, representing a decline of 5.6 per cent. from the previous year, and average operating expenses per minute of usage were 0.215, representing a decline of 22.4 per cent. from the previous year.





Through measures taken to augment the Group's network, optimize network usage during off-peak hours, and increase network resources utilization rate, and by suitably adjusting line capacity and terminating surplus leased lines, the Group has further reduced leased line expenses. The Group's leased line expenses for 2004 were 4,199 million, representing a decline of 25.0 per cent. from the previous year. Leased line expenses accounted for 2.1 per cent. of total operating revenue.

Although voice usage volume increased by 49.4 per cent. from the previous year, as a result of the Group's increased efforts to optimize network structure and careful reorganization and re-routing of traffic volume, network interconnection expenses were 12,705 million in 2004, representing a decrease of 9.7 per cent. from that of the previous year, and its percentage of total operating revenue decreased to 6.2 per cent.

Depreciation expenses were 48,059 million in 2004, representing an increase of 12.7 per cent. from the previous year, which is lower than the increase in operating revenue. Depreciation expenses accounted for 23.6 per cent. of total operating revenue, representing a decline of 0.2 percentage points from that of the previous year. To complement the marketing of voice usage volume and the further development of its new businesses, the Group carried out necessary expansion of its network capacity and constructed various support networks. Notwithstanding the increase in the Group's capital expenditure and related depreciation expenses, the high quality of service provided by the Group's premium networks, the increasing popularity of its new businesses and growth in voice usage volume have not only slowed down the decline in ARPU, but also increased customer loyalty, which together with the growth in the size of its customer base, caused the Group to achieve stable growth in its overall operating revenue. At the same time, the improvements in network efficiency and the reduction in the average depreciation expense per minute from 0.096 in 2003 to 0.073 in 2004 amply demonstrated the effectiveness of the Group's investments.

The Group has always emphasized the importance of a highly-efficient staff management and incentive structure, the continuous promotion of human resources management, the implementation of comprehensive budget management, and effective performance-based evaluations, thereby maintaining a competitive advantage in human resources while effectively controlling personnel expenses. The personnel expenses were 10,655 million in 2004, representing an increase of 9.6 per cent. from the previous year. However, personnel expenses as a percentage of operating revenue amounted to 5.2 per cent., representing a slight decline from the previous year. The Group had a total of 88,127 employees as at 31 December 2004.

Other operating expenses (consisting primarily of sales and marketing expenses, customer services, retention costs, bad debts, administration and other general expenses) were 66,727 million in 2004, representing an increase of 31.6 per cent. from the previous year, and accounted for 32.7 per cent. of the total operating revenue. This increase was a key factor contributing to the rise in the Group's total operating expenses. In order to enhance customer service levels, retain high-value customers and increase customer loyalty, the Group increased its efforts in promotions, marketing and customer service, and sales and marketing expenses increased as a result. In view of the Group's emphasis on rigorous customer credit management and the strict oversight of any defaults in payment by customers, the Group restrained its bad debt ratio to a relatively low level of 1.28 per cent. in 2004, representing a decline of 0.21 percentage points from the previous year. As competition further intensifies and as new businesses develop, sales and marketing expenses are expected to face increasing pressure in the future. However, the Group will continue to pursue refined management methods, to effectively control expenditure growth, to constantly optimize its cost structure, and to emphasize cost effectiveness in order to maximize returns.

EBITDA, Profit from Operations and Net Profit

The Group has consistently worked to create a favorable tax policy environment, has been actively engaged in tax planning and, on the premise that taxes are paid according to law, has endeavored to lower its tax costs. Following the approval of the State Administration of Taxation of China at the end of 2004, certain expenses of the Group have become tax deductible, which brought the Group certain income tax savings, the Group's actual income tax rate in 2004 actually decreased when compared with the previous year, which also led to a greater increase in this year's profit attributable to shareholders.

The Group has endeavored to maintain long-term, sustainable and favorable profit growth. EBITDA margin and net profit margin in 2004 remained relatively high at 55.4 per cent. and 21.2 per cent. respectively. Operating profit was 61,648 million and maintained stable growth. EBITDA was 113,050 million, representing an increase of 11.2 per cent. over the previous year. Profit attributable to shareholders in 2004 was 43,207 million, representing an increase of 15.3 per cent. over the previous year. Audited consolidated basic earnings per share was 2.14, representing an increase of 18.2 per cent. over the previous year. These results reflect the Group's ceaseless efforts to generate improved returns and create value for its shareholders. The Group will continue to focus on developing its core businesses with a view to realizing sustainable and favorable long-term growth.

Strong Cash Flow and Sound Capital Structure

In 2004, the Group continued to maintain a strong cash flow. The Group's actual net cash flow from operating activities was 103,779 million and free cash flow (actual net cash flow from operating activities after deduction of actual capital expenditure incurred) was 42,381 million. At the end of 2004, the Group's total cash and bank balances were 65,413 million, of which 94.6 per cent., 3.3 per cent. and 2.1 per cent. were denominated in RMB, U.S. dollars and Hong Kong dollars, respectively.

To further reduce the cost of capital, the Group continued to reinforce its centralized treasury function, making appropriate allocations of overall capital, thereby enhancing the Group's ability to deploy internal funds with maximum utility. In accordance with its overall capital arrangement, in 2004 the Group redeemed US$600 million due fixed-rate notes with its own funds, and paid part of the consideration for the acquisition of ten mobile telecommunications companies and other telecommunications assets in 2004. Robust cash generating capability and stable capital management have provided a solid foundation for the long-term development of the Group.

At the end of 2004, the Group's debt to capitalization ratio (capitalization represents the sum of total debt and shareholder's equity) was approximately 16.6 per cent. The sum of long-term loans and short-term loans, was 46,557 million, representing an increase of 1,957 million over the previous year, mainly due to the adoption of debt financing for payment of a portion of the purchase consideration for its acquisition of ten mobile telecommunications companies and other telecommunications assets in Mainland China, and the inclusion of net debt of the newly acquired subsidiaries. Nevertheless, the Group's financial position continued to remain at a sound level. Of the total borrowings, 36.8 per cent. was in RMB (consisting principally of RMB bonds, bank loans and finance leases), and 63.2 per cent. was in U.S. dollars (consisting principally of U.S. dollar-denominated convertible notes, as well as the balance of the deferred consideration for the acquisition of the eight and ten provincial telecommunications operators). Approximately 63.8 per cent. of the Group's borrowings were made at floating interest rates. The actual average interest rate of borrowings (including capitalized interest) of the Group in 2004 was approximately 3.72 per cent., whereas the actual interest coverage multiple (ratio of profit before interest and tax to interest expenses) was 37 times. This position reflects the prudent financial risk management policies consistently adopted by the Group, as well as its solid cash flow and sound repayment capability. In the first half of 2004, Standard and Poor's upgraded the Company's corporate credit rating to "BBB+/Positive Outlook" (equivalent to China's sovereign rating) and Moody's also upgraded the Company's corporate credit rating to "A3/Positive Outlook", reflecting that the prudent financial measures consistently adopted by the Group have won further recognition from the market.

Dividends

The Company holds in the highest regard the interests of its shareholders and the returns achieved for its shareholders, especially minority shareholders. Having taken into account such factors as the Company's financial position, cash flow position and requirements to ensure the sustainable future growth of the Company's business, the Board recommends payment of a final dividend of HK$0.46 per share for the financial year ended 31 December 2004. This, together with the interim dividend of HK$0.20 per share already paid during 2004, amounts to an aggregate dividend payment of HK$0.66 per share for the full financial year, representing an increase of 83.3 per cent. over the annual dividend of HK$0.36 per share for the full year of 2003. Dividend payout ratio for 2004 is 32.7 per cent., representing an increase of 11.7 percentage points over the previous year. The Board is of the view that the Company's strong free cash flow is capable of supporting the investments required to maintain the stable growth of the Company, while also providing a favorable cash return to shareholders. The Company will continue its efforts to achieve a sustainable and steadily increasing dividend over the longer term, with a view to generating the best possible return for shareholders.

Effects of Acquisition and Integration

On 1 July 2004, the Company completed its acquisition of ten mobile telecommunications companies and other telecommunications assets in Mainland China, thereby becoming the first overseas-listed PRC telecommunications company operating in telecommunications businesses concurrently in all thirty-one provinces, autonomous regions and municipalities in Mainland China. During the acquisition and restructuring process, the Company seized the opportunity to push forward corporate reform of the newly acquired companies, further enhanced the management and operational efficiency of such companies, increased the Group's economies of scale and growth potential, and continuously enhanced the overall value of the Company. The financial performance of the newly acquired companies surpassed the profit forecast targets as stated in the Company's circular to shareholders dated 3 May 2004 (the "Forecasted Targets") and achieved encouraging operating results for the whole year. As at 31 December 2004, total subscribers of the newly acquired companies reached 28.95 million, representing a net increase of 4.45 million subscribers compared to the end of the previous year and exceeding the forecast by 20,000 subscribers. Operating revenue was 24,615 million, representing a growth of 19.2 per cent. from the previous year. EBITDA reached 12,051 million, representing an increase of 28.4 per cent. from the previous year and exceeding the Forecasted Targets by 80 million. Net profits reached 3,788 million, representing an increase of 79.4 per cent. from last year and exceeding the

Forecasted Targets by 671 million. The operational efficiency of the newly acquired companies also experienced significant improvement. The labour productivity rate at the end of 2004 reached 1,542 users per employee, representing an increase of 14.7 per cent. from the corresponding figure at the end of 2003, the financial year prior to the acquisition. The EBITDA margin reached 49.0 per cent., representing an increase of 3.5 percentage points from the corresponding figure in 2003, the financial year prior to the acquisition. The newly acquired subsidiaries achieved favorable operating results and performance, and have made an immediate and positive impact to the Group's earnings per share in 2004. With the inclusion of the new subsidiaries as part of the Group, and given the increasing effect of synergies in management, the Group believes that it can further leverage the benefits of economies of scale to generate favorable returns for shareholders.

The Group will continue to pursue prudent financial policies, strictly control financial risk, maintain its strong cash-flow generating capability, realize its competitive advantages, allocate its resources in a scientific manner, maintain debt at a sustainable level, lower its overall cost of capital and reinforce and develop favorable economic efficiency, with a view to generating greater returns for our shareholders.