

## **CERTAIN DEFINED TERMS AND CONVENTIONS**

All references to “CTHK Limited” in this annual report on Form 20-F are to China Telecom (Hong Kong) Limited, a company incorporated under the laws of Hong Kong on September 3, 1997. All references to “CTHK” herein are to China Telecom (Hong Kong) Limited and its subsidiaries, Guangdong Mobile Communication Company Limited (“Guangdong Mobile”), Zhejiang Mobile Communication Company Limited (“Zhejiang Mobile”) and, in respect of any time from June 4, 1998, Jiangsu Mobile Communication Company Limited (“Jiangsu Mobile”). In addition, all references to CTHK in respect of any time prior to the incorporation of China Telecom (Hong Kong) Limited are to the cellular telecommunications businesses in Guangdong and Zhejiang provinces of China which were assumed by China Telecom (Hong Kong) Limited and its subsidiaries pursuant to a restructuring (the “IPO Restructuring”) implemented in September 1997 in connection with the initial public offering of CTHK Limited (the “IPO”), as described herein under “Item 1. Description of Business — History of CTHK”.

In this annual report, references to “China” are to the People’s Republic of China including, where the context permits, Hong Kong, and references to “mainland China” are to the People’s Republic of China excluding Hong Kong. References to the “government” are to the government of the People’s Republic of China. References to “Hong Kong” are to the Hong Kong Special Administrative Region of the People’s Republic of China. References to the “MII” are to the Ministry of Information Industry of China or, in respect of references to any time prior to the establishment of the Ministry of Information Industry, the former Ministry of Posts and Telecommunications (the “MPT”). Pursuant to certain resolutions regarding the reorganization of certain ministries of the government passed by the Ninth National People’s Congress in March 1998, the administrative functions of the MPT were assumed by the MII, which is under the direct leadership of the State Council of China (the “State Council”). See “Item 1. Description of Business — Regulation”.

In this annual report, references to “US dollars”, “US\$” or “\$” are to United States dollars, references to “RMB” are to Renminbi, the legal tender currency in mainland China, and references to “HK\$” are to Hong Kong dollars. References to “Hong Kong GAAP” and to “US GAAP” are to generally accepted accounting principles in Hong Kong and the United States, respectively. References to “EBITDA” are to earnings before interest income, interest expense, non-operating income (expense), income taxes, depreciation and amortization. The items of net profit excluded from EBITDA are significant components in understanding and assessing CTHK’s financial performance and CTHK’s computation of EBITDA may not be comparable to other similarly titled measures of other companies.

CTHK publishes its consolidated financial statements in Renminbi. Solely for the convenience of the reader, this annual report contains translations of certain Renminbi and Hong Kong dollar amounts into US dollars and vice versa at specified rates. These translations should not be construed as representations that the Renminbi or Hong Kong dollar amounts actually represent such US Dollar amounts or could be converted into US dollars at the rates indicated or at all. Unless otherwise stated, the translations of Renminbi and Hong Kong dollars into US dollars and vice versa have been made at the rate of RMB 8.2787 to US\$1.00, the rate quoted by the People’s Bank of China, and HK\$7.7476 to US\$1.00, the noon buying rates in New York City for cable transfers in Hong Kong dollars as certified for customs purposes by the Federal Reserve Bank of New York on December 31, 1998. See “Item 8. Selected Financial Data—Exchange Rate Information” for information regarding the noon buying rates from January 1, 1994 through December 31, 1998. On June 15, 1999, the noon buying rates for Renminbi and Hong Kong dollars were RMB 8.2781 to US\$1.00 and HK\$7.7577 to US\$1.00, respectively. Any discrepancies in any table between totals and sums of amounts listed therein are due to rounding.

The statistics set forth in this annual report relating to mainland China are taken or derived from various government publications which have not been prepared or independently verified by CTHK. Such statistics may not be consistent with other statistics compiled within or outside mainland China.

## **FORWARD-LOOKING STATEMENTS**

This annual report contains certain forward-looking statements that are, by their nature, subject to significant risks and uncertainties. Such forward-looking statements include, without limitation, statements relating to CTHK’s business strategy, network expansion plans, including proposed capital investments relating thereto, the planned

development of DCS 1800 systems, the expected impact of tariff changes on CTHK's results of operations, the expected impact of the Year 2000 issue on CTHK's operations, future developments in the telecommunications industry in mainland China, including the proposed restructuring of the industry, and other statements relating to the future business development and economic performance of CTHK. The words "anticipate", "believe", "estimate", "expect", "intend" and similar expressions, as they relate to CTHK, are intended to identify certain of such forward-looking statements. CTHK does not intend to update these forward-looking statements.

Such forward-looking statements reflect the current views of CTHK with respect to future events and are not a guarantee of future performance. Actual results may differ materially from information contained in the forward-looking statements as a result of a number of factors, including, without limitation: any restructuring of the telecommunication industry in mainland China, any changes in regulatory policies of the MII and other relevant government authorities, which could affect, among other things, the granting of any requisite government approvals, interconnection and transmission line arrangements, tariff policy, capital investment priorities and spectrum allocation; the effects of competition on the demand for and price of CTHK's cellular services; any changes in cellular and related technology, which could affect the viability and competitiveness of cellular networks of CTHK; risks and uncertainties related to the Year 2000 issue; and changes in political, economic, legal and social conditions in China including the Chinese government's specific policies with respect to economic growth, inflation, foreign exchange, and the availability of credit. In addition, CTHK's future network expansion and other capital expenditure and development plans are dependent on numerous factors, including the availability of adequate financing on acceptable terms, the adequacy of currently available spectrum or the availability of additional spectrum, the availability of the requisite number of sites for locating network equipment on reasonable commercial terms, the availability of transmission lines and equipment when required, and the availability of qualified management and technical personnel.

#### **SPECIAL NOTE ON THE FINANCIAL INFORMATION OF CTHK PRESENTED IN THIS ANNUAL REPORT**

On June 4, CTHK Limited acquired Jiangsu Mobile. See "Item 1. Description of Business—History of CTHK." As required under Hong Kong GAAP, CTHK has adopted the acquisition method to account for the acquisition of Jiangsu Mobile. Accordingly, the consolidated financial statements of CTHK include the results of Jiangsu Mobile from June 4, 1998, the date of acquisition. Similarly, all other Hong Kong GAAP financial information of CTHK presented in this annual report includes the results of Jiangsu Mobile only from June 4, 1998.

For US GAAP, as a result of both CTHK and Jiangsu Mobile being under common control prior to the acquisition, such acquisition was considered a "combination of entities under common control". Under US GAAP, combinations of entities under common control are accounted for under the "as if pooling-of-interests" method, whereby assets and liabilities are accounted for at historical cost and the financial statements of previously separate companies for periods prior to the combination generally are restated on a combined basis. The cash consideration paid by CTHK has been treated as an equity transaction in the year of acquisition for US GAAP purposes. The acquisition of Jiangsu Mobile had a material impact on CTHK's overall financial performance for the year ended December 31, 1998. See "Item 9. Management's Discussion and Analysis of Financial Condition and Results of Operations".

## GLOSSARY

In this annual report, unless the context otherwise requires, the following terms have the respective meanings set out below.

analog . . . . .	Communications by transmission of continuously varying representations of the input signal, as compared to binary coding in digital transmission.
base station controller . . . . .	Equipment that monitors and controls one or more base stations (message exchange and frequency administration).
base station; base transceiver station . . . . .	Transmitter and receiver which serves as a bridge between all mobile users in a cell and connects mobile calls to the mobile switching center.
CDMA . . . . .	Code Division Multiple Access technology, which is a continuous digital transmission technology that accommodates higher throughput by using various coding sequences to mix and separate voice and data signals for wireless communication.
cell . . . . .	Coverage area of the whole or part of a base station.
cell site . . . . .	The entire infrastructure and radio equipment associated with a cellular transmitting and receiving station, including the land, building, tower, antennas and electrical equipment.
cellular system . . . . .	A telephone system based on a grid of cells deployed at a specified frequency.
channel . . . . .	Communication path for transmitting voice.
churn rate . . . . .	Subscriber disconnections rate for a given period, determined by dividing the sum of voluntary and involuntary deactivations during the period by the number of subscribers at the end of the same period.
cloning . . . . .	The fraudulent practice of programing unauthorized handsets with duplicated electronic serial or mobile identification numbers.
DCS 1800 . . . . .	Digital Cellular System for 1800 MHZ, a European digital cellular standard based on GSM technology that operates in the 1800 MHZ frequency band (also referred to as PCN).
DDD . . . . .	Domestic Direct Dialing, the capability to directly dial domestic long distance calls from one's own telephone.

digital .....	A method of storing, processing and transmitting information through the use of distinct electronic or optical pulses that represent the binary digits 0 and 1. Digital transmission and switching technologies employ a sequence of discrete, distinct pulses to represent information, as opposed to the continuously variable analog signal.
dual band handset .....	A mobile or portable telephone which is capable of operating in two different frequency bands (such as that proposed for GSM-900 and DCS-1800).
frequency .....	The number of cycles per second, measured in hertz, of a periodic oscillation or wave in radio propagation.
GSM .....	Global System for Mobile Communications, pan-European mobile telephone system operating in the 900 MHZ frequency band based on digital transmission and cellular network architecture with roaming. GSM is the standard accepted in most of Europe, the Middle East, Africa, Australia and Asia (with the exception of, among others, Japan and South Korea).
GSM-900 .....	A GSM network in the 900 MHZ frequency range.
IDD .....	International Direct Dialing, the capability to directly dial telephones in foreign countries from one's own telephone.
interconnect .....	Any variety of hardware arrangements that permit the connection of telecommunications equipment to a communications common carrier network such as a public switched telephone network.
MHz .....	Megahertz, a unit of measure of frequency; 1 MHz is equal to one million cycles per second.
mobile switching center .....	A central switching point to which each call is connected, which controls the routing of calls. A mobile switching center allows cellular telephone users to move freely from cell to cell while continuing their calls.
network infrastructure .....	Fixed infrastructure equipment consisting of base transceiver stations, base station controllers, antennas, switches, management information systems and other equipment that receives, transmits and processes signals from and to subscriber equipment and/or between wireless systems and the public switched telephone network.
penetration .....	Number of subscribers per 100 population.

penetration rate . . . . .	Total market subscribers divided by population of the service area.
PSTN . . . . .	Public switched telephone network, which comprises the network infrastructure necessary for providing basic telephone services.
roaming . . . . .	A service offered by mobile communications network operators which allows a subscriber to use his or her handset while in the service area of another carrier. Roaming requires an agreement between operators of different individual markets to permit customers of either operator to access the other's system.
SIM card . . . . .	Subscriber Identity Module card, an electronic card that is inserted into a handset and identifies the subscriber to the network. The SIM card contains the personal identification number of the subscriber and identifies the network to which the subscriber belongs.
spectrum . . . . .	The range of electromagnetic frequencies available for use.
switch . . . . .	A mechanical, electrical or electronic device which opens or closes a circuit, completes or breaks an electrical path, or selects paths or circuits used to route traffic between the mobile system and the PSTN.
TACS . . . . .	Total Access Communication Systems, a European standard for analog mobile telephone transmissions in the 800 and 900 MHZ frequency bands.
transmission line . . . . .	Dedicated telecommunications transmission line linking one fixed point to another.

## PART I

### Item 1. Description of Business.

CTHK is the leading provider of cellular telecommunications services in Guangdong, Zhejiang and Jiangsu provinces in mainland China. Guangdong, Zhejiang and Jiangsu are among mainland China's most economically developed provinces and, as of December 31, 1998, were among the provinces in mainland China with the largest number of cellular subscribers. As of such date, CTHK serviced an aggregate subscriber base of approximately 6.53 million, which accounted for an estimated 94.5% of cellular subscribers in these provinces and an estimated 26.1% of all cellular subscribers in mainland China. In 1998, CTHK had operating revenue of RMB 26,345.4 million (US\$3,182.3 million), EBITDA of RMB 12,586.6 million (US\$1,520.4 million), net profit of RMB 6,899.8 million (US\$833.4 million) and cash flows from operating activities of RMB 13,566.8 million (US\$1,638.8 million). See "Item 9. Management's Discussion and Analysis of Financial Condition and Results of Operations".

CTHK believes that the cellular telecommunications industry in mainland China is undergoing a period of rapid development and has potential for substantial future growth. CTHK's principal objective is to become a world-class telecommunications company by taking advantage of its leading position in its existing markets to strengthen its competitive advantage and by adopting international best practice management methods to increase its subscriber base and subscriber usage and to improve profitability. In order to achieve its objective, CTHK's strategy emphasizes external growth through continuing efforts to explore opportunities for the acquisition of cellular and other telecommunications businesses in mainland China, as well as organic growth through continuing expansion of its network capacity and coverage, enhancement of network quality and service features, increased focus on marketing and distribution, and careful control of operating costs and management of revenue.

### History of CTHK

Prior to the IPO Restructuring implemented in September 1997, CTHK's TACS and GSM cellular networks in Guangdong were owned by Guangdong Mobile, a state-owned enterprise formed in September 1988. Prior to the IPO Restructuring, CTHK's GSM cellular network in Zhejiang was owned by Zhejiang Mobile, a limited liability company formed in February 1996 and 98.55% owned by the Zhejiang Posts and Telecommunications Administration ("PTA"), and CTHK's TACS cellular network in Zhejiang was owned by the Zhejiang PTA.

Pursuant to the IPO Restructuring, CTHK Limited was incorporated under the laws of Hong Kong on September 3, 1997. The TACS network owned by the Zhejiang PTA was transferred to Zhejiang Mobile, and 99.63% of the equity interest in Zhejiang Mobile was then transferred to the former MPT (now the MII), which, in turn, transferred its 100% equity interest in Guangdong Mobile and 99.63% equity interest in Zhejiang Mobile to CTHK Limited. Following such transfer, Guangdong Mobile was transformed into a wholly-owned foreign enterprise and Zhejiang Mobile was transformed into a Sino-foreign joint venture. In addition, certain personnel previously employed by the Posts and Telecommunications Bureaus ("PTBs") in Guangdong and Zhejiang and involved in the operations of the cellular networks in the two provinces were transferred to Guangdong Mobile and Zhejiang Mobile, respectively.

At the first session of the Ninth National People's Congress in March 1998, a motion was passed to implement the restructuring of government bodies. The MII was established to assume all the government functions of the former MPT. CTHK Limited is ultimately controlled by the MII, and CTHK has received reassurance that the MII will assume all undertakings given by the former MPT at the time of the IPO of CTHK Limited. See "Item 4. Control of Registrant" and "Item 13. Interest of Management in Certain Transactions".

On June 4, 1998, CTHK Limited acquired the entire ownership interest in China Telecom Jiangsu Mobile (BVI) Limited, which is the sole direct owner of Jiangsu Mobile, from its controlling shareholder, China Telecom Hong Kong (BVI) Limited, at a cash consideration of HK\$22,475 million (US\$2,900 million). The financial statements of CTHK included herein, which are prepared and presented in accordance with Hong Kong GAAP, and all other Hong Kong GAAP financial information in this annual report include the results of Jiangsu Mobile from the date of the acquisition.

The acquisition of Jiangsu Mobile has had a material impact on CTHK's overall results of operations. See "Item 9. Management's Discussion and Analysis of Financial Condition and Results of Operations — Acquisition of Jiangsu Mobile". As previously noted, all operational information presented in this annual report include the results of Jiangsu Mobile from January 1, 1998. See "Special Note on Presentation of Financial and Operational Information".

In connection with the IPO Restructuring and the acquisition of Jiangsu Mobile, CTHK entered into various services agreements and certain other agreements with the Directorate General of Telecommunications (the "DGT"), a state-owned enterprise established by and under the control of the MII, and the relevant provincial PTAs. See "Item 13. Interest of Management in Certain Transactions". The DGT and the telecommunications operations of the PTAs and the PTBs are collectively referred to herein as the "China Telecom system".

According to a draft plan for the restructuring of the telecommunications industry in mainland China, the China Telecom system will be reorganized based on business lines, and it is anticipated that CTHK may come under the control of the China mobile telecommunications company to be established under such plan. CTHK cannot predict what effect, if any, the restructuring will have on its business and operations.

## **Operations**

CTHK offers cellular telecommunications services in each of Guangdong, Zhejiang and Jiangsu using TACS and GSM technologies. CTHK's cellular telephone networks reach all cities and counties and more than 95% of the major highways in all three provinces.

### ***Subscribers and Usage***

CTHK had a total of approximately 6.53 million cellular subscribers as of December 31, 1998. CTHK's subscriber base has grown substantially over the three years ended December 31, 1998. In Guangdong, the number of CTHK's subscribers grew from approximately 1.57 million at the end of 1996 to approximately 3.62 million at the end of 1998, representing a compound annual growth rate of approximately 52.0%. In Zhejiang, CTHK's subscriber base grew from approximately 475,000 at the end of 1996 to approximately 1.51 million by the end of 1998, representing a compound annual growth rate of approximately 78.1%. In Jiangsu, CTHK had a subscriber base of approximately 1.40 million at the end of 1998. As of December 31, 1998, CTHK's subscribers in Guangdong, Zhejiang and Jiangsu accounted for approximately 14.5%, 6.0% and 5.6%, respectively, of all cellular subscribers in mainland China. CTHK believes that its subscriber growth has been attributable to numerous factors, including significant economic growth in Guangdong, Zhejiang and Jiangsu, expansion in the coverage of CTHK's networks, increased marketing and sales efforts and improved distribution channels of CTHK, increases in the number of fixed lines, decreased cost of initiating service due to a general decline in handset prices and CTHK's connection fees and enhanced roaming capabilities and value added services.

The following table sets forth selected historical information about CTHK's cellular subscriber base for the periods indicated:

	<b>As of or for the year ended December 31,</b>		
	<b>1996</b>	<b>1997</b>	<b>1998</b>
Subscribers (in thousands)			
Guangdong .....	1,568	2,502	3,623
Zhejiang .....	475	903	1,507
Jiangsu .....	—	—	1,401
Total .....	2,043	3,405	6,531
Penetration (%) <sup>(1)</sup>			
Guangdong .....	2.27	3.57	5.50
Zhejiang .....	1.08	2.04	3.07
Jiangsu .....	—	—	1.97
Average churn rate (%) <sup>(2)</sup> (churn rate (%) <sup>(2)</sup> )			
Guangdong .....	0.80 (0.66)	1.18 (0.96)	1.87 (1.58)
Zhejiang .....	2.90 (2.21)	2.93 (2.24)	2.06 (1.64)
Jiangsu <sup>(3)</sup> .....	—	—	2.85 (2.32)

- (1) Penetration in a province is determined by dividing CTHK's subscribers in such province by the total population of such province.
- (2) Both rates measure the rate of subscriber disconnections from cellular telephone service, determined by dividing the sum of voluntary and involuntary deactivations (excluding deactivations due to subscribers switching from CTHK's TACS networks to CTHK's GSM networks) during a year by, (i) in the case of average churn rate, the average of the number of subscribers at the beginning and the end of such year, and (ii) in the case of churn rate, the number of subscribers at the end of such year.
- (3) CTHK acquired Jiangsu Mobile in June 1998. The average churn rate and the churn rate of Jiangsu Mobile in respect of the full year of 1998 are presented for ease of comparison and are calculated based on the relevant information of Jiangsu Mobile prior to and after its acquisition by CTHK.

The size and composition of CTHK's subscriber base and subscribers' usage patterns have evolved over the last few years. When cellular telecommunications services first became commercially available in mainland China, the subscriber base consisted primarily of senior managers of state-owned enterprises, high-level government officials, individual entrepreneurs and managers of large private enterprises. As the price of handsets and connection fees has decreased and cellular technology has improved, cellular services have become increasingly popular with the broader middle income market for both business and social uses. Such subscribers generally incur lower average monthly usage and are generally more price-sensitive. Accordingly, as is typical in many countries with developing cellular markets, the average usage and revenue per subscriber have declined over the last few years as CTHK's cellular telephone penetration has increased. See "— Tariffs". Notwithstanding such declines, total minutes used by customers of CTHK



grew from approximately 10.0 billion minutes in 1996 to approximately 25 billion minutes in 1998 (including 4.6 billion minutes for Jiangsu Mobile for the full year of 1998).

The following table sets forth selected historical information about CTHK's cellular subscriber usage for the periods indicated:

	<b>Year ended December 31,</b>		
	<b>1996</b>	<b>1997</b>	<b>1998</b>
Minutes of usage (in billions)			
Guangdong .....	7.7	10.7	14.7
Zhejiang .....	2.3	3.7	5.7
Jiangsu <sup>(1)</sup> .....	—	—	4.6
Average minutes of usage per subscriber per month <sup>(2)</sup>			
Guangdong .....	498	438	400
Zhejiang .....	540	448	396
Jiangsu <sup>(1)</sup> .....	—	—	335
Average revenue per subscriber per month (RMB) <sup>(3)</sup>			
Guangdong .....	499	454	452
Zhejiang .....	613	534	443
Jiangsu .....	—	—	n/a <sup>(4)</sup>

- (1) CTHK acquired Jiangsu Mobile in June 1998. The minutes of usage and average minutes of usage per subscriber per month of Jiangsu Mobile in respect of the full year of 1998 are presented for ease of comparison and are calculated based on the relevant information of Jiangsu Mobile prior to and after its acquisition by CTHK.
- (2) Average minutes of usage per subscriber per month is calculated by (i) dividing the total billable minutes of usage during the year by the average number of subscribers during such year (calculated as the average of the period-beginning and period-end number of subscribers) and (ii) dividing the result by 12 months.
- (3) Average revenue per subscriber per month is calculated by (i) dividing the operating revenue during the year by the average number of subscribers during such year (calculated as the average of the period-beginning and period-end number of subscribers) and (ii) dividing the result by 12 months.
- (4) Not available for the full year of 1998 because the operating revenues of Jiangsu Mobile are included in CTHK's financial results only from June 4, 1998, the date of its acquisition by CTHK.

### ***Tariffs***

The tariffs payable by CTHK's subscribers are primarily usage charges, connection fees, monthly fees and monthly service fees for value added services. Usage charges reflect charges for both incoming and outgoing calls (with respect to both local and roaming services), plus, where applicable, an additional component reflecting domestic and international long distance tariffs set by the MII and the State Development and Planning Commission (the "SDPC"). Subscribers also pay fees for selection of specific telephone numbers.

On initial subscription, CTHK's new subscribers are charged a connection fee for service activation. After initial connection, subscribers are required to pay a fixed monthly fee. Subscribers are not entitled to any "free minutes" of usage. Subscribers incur base usage charges on a per minute basis for both incoming and outgoing calls, plus applicable long distance charges. For calls made or received by subscribers who are roaming outside of their registered service area, subscribers incur a higher base usage charge, plus applicable long distance charges. CTHK's base usage charges are the same for TACS and GSM services. In 1998, CTHK began offering tailored service packages and adopted flexible long distance tariff plans distinguishing between day and night and peak and non-peak hours, based upon customer requirements as well as the functions and features of CTHK's network resources.

CTHK's tariffs are subject to regulation by various government authorities, including the SDPC, the MII and the relevant provincial price regulatory authorities and PTAs. The connection fee is based on a guidance price range set jointly by the MII and the SDPC and applicable to all cellular operators in the same province with the actual tariff determined by the relevant provincial PTAs in consultation with the relevant price regulatory authorities. In general, base usage charges, monthly fees and domestic roaming charges are determined jointly by the MII and the SDPC. See "—Regulation — Tariff Setting and Price Controls". In connection with the IPO of CTHK Limited, the MII confirmed that CTHK's tariffs conform to such specified prices or price range, with deviations approved by the relevant government authorities.

CTHK has from time to time adjusted certain of its tariffs. In particular, connection fees in Guangdong, Zhejiang and Jiangsu have been substantially reduced in the past three years, accompanying a reduction in the guidance prices for connection fees over such period as CTHK's cellular operations developed. In 1999, there were reductions in the connection fee in Guangdong, Zhejiang and Jiangsu, the monthly fee in Guangdong and Zhejiang and the base usage charge in Jiangsu. All the fees levied by CTHK comply with the standard fee schedules stipulated by the relevant provincial regulatory authorities. There can be no assurance that tariffs will not be further reduced in the future. However, CTHK believes that while tariff reductions may reduce revenue in the short term, they may help to expand CTHK's subscriber base and result in increased total subscriber usage of CTHK's cellular services, thereby contributing to CTHK's revenue growth in the long term.

#### ***Interconnection Revenue and Costs***

CTHK's networks interconnect with the China Telecom system's fixed line network, or PSTN, allowing CTHK's subscribers to communicate with fixed line subscribers and subscribers to other cellular networks and to make and receive domestic and international long distance calls. CTHK receives from the relevant provincial PTAs fees for incoming calls that involve interconnection with the PSTN and pays to the relevant provincial PTAs fees for outgoing calls that involve interconnection with the PSTN. A majority of all calls on CTHK's networks involve interconnection with the PSTN, including certain calls made between cellular subscribers of CTHK and other cellular operators.

Prior to the IPO Restructuring, an interconnection arrangement existed between Zhejiang Mobile and the Zhejiang PTA with respect to CTHK's GSM network in Zhejiang. However, no formal interconnection arrangements existed for CTHK's TACS and GSM networks in Guangdong or for CTHK's TACS network in Zhejiang. In October and September 1997, Guangdong Mobile and Zhejiang Mobile entered into interconnection agreements with the Guangdong PTA and the Zhejiang PTA, respectively, which have been renewed in October 1998. Jiangsu Mobile entered into a similar interconnection agreement with the Jiangsu PTA in April 1998. Settlement of interconnection payments between CTHK and the relevant PTAs is made on a monthly basis.

Under these agreements, with respect to incoming local calls originating on the fixed line public network and terminating on CTHK's networks, CTHK receives from the relevant PTA, in addition to the cellular usage fee it collects from its subscriber receiving the call, 10% of the PTA's fixed line tariff. With respect to outgoing local calls originating on CTHK's networks and terminating on the public fixed line network, CTHK collects the cellular usage fee from the subscriber making the call and pays to the relevant PTA 80% of the PTA's fixed line tariff. The fixed line tariffs for local calls in Guangdong, Zhejiang and Jiangsu were increased effective March 1, 1999.

With respect to long distance calls made by CTHK's subscribers, CTHK collects from its subscribers the applicable fixed line long distance tariffs, and pays a portion (in the case of domestic long distance calls) or the full amount (in the case of international long distance calls) of such revenues to the relevant PTA. The rates at which CTHK makes such payments to the relevant PTA are applicable to all cellular operators in mainland China. With respect to long distance calls made to CTHK's subscribers by fixed line subscribers or subscribers to other cellular networks, CTHK receives from the relevant PTA a portion of the applicable fixed line tariffs collected by the PTA from the callers. The fixed line tariffs for international long distance calls made in Guangdong, Zhejiang and Jiangsu were decreased effective March 1, 1999.

CTHK's subscribers can also make calls to and receive calls from subscribers of China Unicom Telecommunications Corporation ("Unicom") through interconnection with the PSTN. Interconnection revenue and cost sharing arrangements between CTHK and the relevant PTAs with respect to such calls are calculated on the same basis as calls between CTHK's subscribers and users of the China Telecom system's PSTN.

### ***Roaming Services***

CTHK offers automatic roaming services to its subscribers, which permit its subscribers to make and receive telephone calls while they are outside of their registered service area including while in the coverage area of other cellular networks with which the user's home system has a roaming arrangement. Both CTHK's TACS and GSM networks offer roaming services throughout mainland China. In addition, CTHK's GSM networks offer roaming in 38 countries and regions around the world (including Hong Kong, Macau and Taiwan). The scope of international roaming is determined by applicable agreements between the DGT, on behalf of CTHK and other cellular service providers within the China Telecom system, and international cellular operators.

A cellular telephone customer using roaming services is charged at CTHK's roaming usage rate for both incoming and outgoing calls, plus applicable long distance charges. See "— Tariffs". Under current MII regulations, CTHK is entitled to 20% of the roaming usage revenues generated by its subscribers for off home-location roaming ("roaming out") in mainland China, with the balance paid to the visited cellular system operator in whose coverage area the roaming customers make or receive the call. Conversely, CTHK is entitled to 80% of the roaming usage revenues charged by other cellular operators in mainland China to customers for visitor-location roaming ("roaming in") within CTHK's coverage area. With respect to roaming in Hong Kong, Taiwan and Macau and international roaming, CTHK shares roaming revenues with other cellular operators in accordance with the applicable roaming agreements entered into between the DGT and such operators. All payments relating to roaming are settled by CTHK through the DGT.

### ***Value Added Service Features***

CTHK offers a number of optional value added services to its subscribers. Such services include call forwarding, call waiting, conference calling, call limitation, voicemail and short message services. Certain advanced functions, such as caller identification, BPS data transfer (which allows a user to dial into modem access using a cellular handset) and facsimile transmissions, are also available on CTHK's GSM networks. CTHK has also introduced stored value cards and public mobile phone cards for the convenience of its customers. CTHK intends to expand its range of value added services, which it believes can be achieved with modest expenditures. CTHK intends to concurrently educate its subscribers about the benefits of value added services through enhanced marketing and promotional efforts, as CTHK believes that the extent to which it will expand its value added service features depends more on customer awareness and demand than on technical capabilities of its networks.

### ***Customer Service and Billing***

CTHK provides a full range of services that emphasize customer care from the point of sale onward. At the point of sale, after all application procedures have been completed, CTHK is generally able to activate new subscriber connections within a few hours for its GSM services and within 24 hours for its TACS services. CTHK's after-sales

customer support services include customer service hotlines in CTHK's service areas. Such hotlines provide customers with billing and service information, as well as receive customer reports of network problems.

Generally, CTHK has the same settlement policy for its subscribers in different service areas, requiring such subscribers to settle their individual accounts on a monthly basis. Subscribers may make payment either through direct debit accounts established at certain branches of banks and certain post offices, or by paying in person at numerous authorized retail outlets in various cities and counties. Subscribers can also pay in person at outlets operated by any of CTHK's authorized dealers within the China Telecom system. Detailed statements are made available upon the subscriber's request. In Guangdong and Zhejiang provinces, CTHK has introduced, on a limited basis, pre-paid SIM cards designed for the convenience of its customers, which also has the benefit of reducing bad debt.

CTHK imposes a late payment fee on each subscriber whose account is not paid by the monthly due date. CTHK's current policy is to deactivate the subscriber's services (i.e. an involuntary deactivation) if such subscriber's account remains overdue after 30 days. Subscribers whose services have been involuntarily deactivated must pay all overdue amounts, including applicable late payment fees, to reactivate services. CTHK does not require subscribers to post any deposit before the initiation of service. Despite the lack of widely available credit information services in mainland China, CTHK has implemented certain subscriber registration procedures, such as identity checking and background checking for corporate customers, to assist in credit control. CTHK provides for all accounts receivable aged over 90 days. The total amount of the provision for doubtful accounts for each of the three years ended December 31, 1996, 1997 and 1998 was RMB 227.4 million, RMB 449.1 million and RMB 558.1 million, respectively, or 2.2%, 2.9% and 2.1% of total operating revenue, respectively.

### ***Information Systems***

CTHK's information technology infrastructure consists primarily of three computerized information systems: the business operations support system ("BOSS"), the management information system ("MIS"), and CTHK's internal business communications network. CTHK's BOSS provides day-to-day operational support to various business units of CTHK, including customer care, billing and collection, and sales and marketing. CTHK's MIS collects data, including operational and financial data, so that management and marketing personnel can monitor subscriber satisfaction, analyze trends in calling patterns, target network expansion and develop appropriate marketing strategies. The internal business communications network of CTHK allows internal communications through its intranet, video conference system and communications platform system. CTHK is currently in the process of upgrading its information systems, with the goal of improving efficiencies especially in data collection and customer service.

In order to safeguard against any risks associated with the "Year 2000 issue", CTHK is currently examining its information systems and, where appropriate, upgrading or modifying such systems. See "Item 9. Management's Discussion and Analysis of Financial Condition and Results of Operations — Year 2000 Readiness Disclosure".

### ***Service Distribution and Marketing***

Since early 1997, CTHK has significantly expanded its marketing and distribution efforts to attract a growing number and increasingly diverse base of potential subscribers. CTHK's marketing strategies focus on expanding its distribution network and emphasizing the wide coverage of its networks, customer service and the development of its brand name image.

*Distribution Channels.* CTHK markets its cellular services through a wide network of authorized dealers and through its own retail outlets. As of December 31, 1998, CTHK had 3,244 authorized dealers, consisting of 1,248 dealers that are owned and operated by various entities within the China Telecom system and 1,996 dealers that are unaffiliated with the China Telecom system. As part of the IPO Restructuring and the acquisition of Jiangsu Mobile, CTHK entered into various distribution and marketing agreements with the relevant PTAs in Guangdong, Zhejiang and Jiangsu provinces. Many of CTHK's authorized dealers within the China Telecom system are telecommunications retail outlets and post offices that offer such other services as the sale of handsets. In addition to marketing CTHK's services,

CTHK's authorized dealers also perform various services for CTHK, such as payment collection and the provision of billing information and other customer services. The authorized dealers market and sell CTHK's cellular services at prices determined by CTHK in accordance with the applicable price schedules in the relevant provinces. In connection with such sales, such dealers pay to CTHK all related connection fees and other miscellaneous fees payable upon initial connection. CTHK in turn pays such dealers a fee of not more than RMB 300 per new subscriber acquired. The commission structure has been determined taking into account factors such as the results of market research and the revenues and costs of the products and is the same for all dealers whether or not they are affiliated with the China Telecom system. CTHK offers training to the sales employees of its dealers and its own sales force with respect to CTHK's system, products and services so that such sales employees and agents, in turn, can provide information to current and prospective customers.

CTHK also owns and operates 245 retail outlets. In addition to serving as outlets where customers can subscribe for CTHK's network services, certain of such outlets also sell handsets and most offer customers after-sales support services, including the repair of handsets and collection of payment. CTHK is seeking to develop other distribution channels in order to further strengthen its marketing efforts.

In addition, CTHK distributes its cellular services pursuant to certain distribution agreements entered into by Guangdong Mobile between August 1996 and June 1997 with certain distributors of telecommunications services. Pursuant to such agreements, Guangdong Mobile has agreed to allocate up to an aggregate of 250,000 cellular numbers for its GSM network to such distributors, who act as resellers of Guangdong Mobile's cellular services. The resellers pay to Guangdong Mobile a fee of RMB 9,167 for each cellular number to be allocated and receive the right to a substantial portion of the revenues generated by subscribers of such numbers during the seven-year term of the agreements. CTHK is entitled to the other revenues during the term of the agreements and thereafter all revenue generated by the subscribers of such cellular numbers. The resellers will bear the full risk and losses arising from any default on payment by such subscribers during the term of the reseller agreements and are required to comply with the marketing and tariff guidelines established by Guangdong Mobile. As of June 15, 1999, agreements with seven resellers independent from CTHK were in effect and substantially all the numbers had been allocated to and paid for by the resellers.

While the reseller agreements provide CTHK with an immediate source of operating cash flow and may reduce the costs associated with marketing and distribution during such period, the revenue recognized and the cash received by CTHK from subscribers of such cellular numbers will likely be substantially less than the revenue and cash flow that would have been recognized and received, respectively, if Guangdong Mobile had retained the rights to all the revenue generated from the subscribers of such cellular numbers. CTHK does not intend to enter into agreements on terms substantially similar to the reseller agreements in the foreseeable future.

*Brand Name.* As the first and the leading cellular telephone services provider in its markets, CTHK believes it is well positioned to develop the image of its brand name. Pursuant to a non-exclusive license agreement with the DGT entered into in September 1997, CTHK markets its services under the "China Telecom" logo, which is a registered trademark owned by the DGT. "China Telecom" is the marketing name used throughout mainland China by all telecommunications services providers within the China Telecom system, including the Guangdong, Zhejiang and Jiangsu PTAs. Under the agreement, no license fee is payable by CTHK for the first three years and the fees payable thereafter, if any, shall be no less favorable than fees paid by other entities within the China Telecom system for the use of such trademark logo. The DGT may license the trademark to other parties but may not unilaterally terminate the license agreement. However, CTHK cannot predict what effects, if any, the restructuring of the telecommunications industry in mainland China will have on its licensing arrangements with the DGT. CTHK currently intends to invest in a combination of television, radio, newspaper and billboard advertising and promotional programs that emphasize CTHK's wide network coverage, range of available service features, and quality customer services.

## **Cellular Networks**

Each of CTHK's GSM networks consists of:

- ! cell sites, which are physical locations equipped with a base transceiver station containing transmitters, receivers and other equipment that communicate through radio channels with cellular telephone handsets within the range of a cell;
- ! base station controllers, which connect to, and control, the base transceiver station within each cell;
- ! mobile switching centers, which in turn control the base station controllers and the routing of calls; and
- ! leased transmission lines, which link the mobile switching centers, base station controllers, base transceiver stations and the China Telecom system's PSTN.

CTHK's TACS networks are identical to its GSM networks in terms of network infrastructure, except that the TACS networks do not employ base station controllers. Instead, base transceiver stations are controlled by, and communicate directly with, the mobile switching centers.

CTHK commenced offering cellular telephone services with the establishment of TACS networks in Guangdong in November 1987 and Zhejiang in May 1992. CTHK launched its GSM cellular networks in Guangdong in July 1995 and Zhejiang in December 1995. Jiangsu Mobile commenced offering cellular services in Jiangsu in December 1992 with the establishment of a TACS network and launched its GSM operations in December 1995 on a full commercial basis. CTHK's TACS and GSM networks currently provide coverage in all cities and counties and more than 95% of the major highways in all three provinces.

The following table sets forth certain selected information regarding CTHK's TACS and GSM networks in Guangdong, Zhejiang and Jiangsu as of December 31, 1998:

	<b>As of December 31, 1998</b>		
	<b>Guangdong</b>	<b>Zhejiang</b>	<b>Jiangsu</b>
Subscribers (in thousands)			
TACS .....	807	373	590
GSM .....	2,816	1,134	811
Total .....	3,623	1,507	1,401
Subscriber capacity (in thousands)			
TACS .....	961	497	723
GSM .....	3,232	1,663	2,481
Total .....	4,193	2,160	3,204
Mobile switching centers			
TACS .....	26	18	33
GSM .....	58	35	33
Total .....	84	53	66
Base station controllers*			
GSM .....	96	147	95
Base transceiver stations			
TACS .....	1,199	706	1,284
GSM .....	2,716	1,849	2,445
Total .....	3,915	2,555	3,729

\* In a TACS system, the base transceiver stations are connected directly to the mobile switching centers. Accordingly, CTHK's TACS networks do not utilize any base station controllers.

### ***Transmission Infrastructure***

The physical infrastructure linking CTHK's base transceiver stations, base station controllers and mobile switching centers and interconnecting CTHK's networks to the PSTN consists of transmission lines, which provide the backbone infrastructure by which cellular call traffic is carried. CTHK currently leases transmission lines from the Guangdong, Zhejiang and Jiangsu PTAs, and pays the relevant PTA a fee based on tariff schedules stipulated by the MII. See "Item 13. Interest of Management in Certain Transactions". CTHK is also capable of developing its own transmission infrastructure and, when necessary, may build its own lines in certain areas where the PTAs do not currently have any transmission lines in place or where the leasing of existing lines is not economically feasible. See "— Network Capacity Expansion Plans".

### ***Network Operations and Maintenance***

CTHK believes that it has acquired considerable experience and technical expertise in developing and operating cellular telecommunications networks in mainland China. Day-to-day traffic management, troubleshooting and system maintenance are conducted by its experienced team of engineers and technicians, and technical staff are available for emergency repair work 24 hours a day. In addition, CTHK employs specialist teams for central maintenance of the networks. CTHK continues to seek to attract and retain qualified technical staff. Currently, most technical difficulties relating to the networks are resolved by CTHK's staff, although CTHK's equipment suppliers also provide back-up maintenance and technical support. CTHK maintains stocks of certain spare parts, such as circuit boards and antennae, and believes that it would be able to obtain suitable replacements for parts which it does not stock in a timely and commercially reasonable manner. To date, CTHK has not experienced any technical difficulties which have resulted in a material interruption in cellular network services.

### ***Network Capacity Expansion Plans***

CTHK intends to continue its network development in Guangdong, Zhejiang and Jiangsu, with an emphasis on increasing the coverage and capacity of its GSM networks, and improving the operating efficiency of its GSM and TACS networks.

CTHK intends to achieve capacity expansion by adding cell sites in areas already within its network coverage and by expanding coverage, including expanding coverage along railways and highways and improving indoor coverage. CTHK's network expansion plans depend to a large extent upon the availability of sufficient spectrum. As GSM networks offer greater capacity given the same spectrum bandwidth, CTHK may, from time to time, reallocate part of its allotted spectrum from its TACS networks to its GSM networks to accommodate capacity expansion requirements. In addition, in order to alleviate moderate congestion that has developed in certain major urban centers with a high density of cellular subscribers, CTHK has introduced GSM-compatible DCS 1800 systems to add capacity in such areas. In addition, CTHK is closely following commercial applications of "third generation" cellular telecommunications technology in relation to the possible transition of its networks from existing "second generation" technology to the "third generation" in the future.

The timing and extent of CTHK's planned network expansion will depend on factors such as demand for coverage and the relevant PTA's transmission infrastructure development plans. In addition, the actual rate of network expansion in each province will depend upon an increase in subscriber demand and CTHK's ability to finance its capital expenditure requirements. The realization of CTHK's future expansion programs will also be subject to the receipt of relevant government approvals. There can be no assurance that CTHK will be able to implement its network expansions as planned.

### ***Spectrum***

A cellular system's capacity is to a certain extent limited by the amount of frequency spectrum available for use by the system. CTHK has been approved by the former State Radio Regulatory Commission ("SRRC") (whose

governmental functions have been assumed by the MII) to use 19 MHz of spectrum in the 900 MHz frequency band for an indefinite term in each of Guangdong, Zhejiang and Jiangsu and, in addition, 5 MHz of spectrum in the 900 MHz frequency band in each of Guangdong and Zhejiang and 6 MHz in Jiangsu until 2005. Such spectrum allocation may be renewed with approval of the MII. In total, CTHK currently has 24 MHz of spectrum in each of Guangdong and Zhejiang and 25 MHz of spectrum in Jiangsu in the 900 MHz frequency band.

CTHK may adjust its current spectrum allocation between its TACS and GSM networks by reallocating spectrum from TACS networks to GSM networks to satisfy anticipated capacity requirements. CTHK expects that technical development of its networks will result in more efficient use of frequency spectrum and that, subject to approval by the MII, by reallocating available spectrum between its TACS and GSM networks as required, CTHK will be able to return the temporary spectrum allocation on a timely basis without any material adverse effect on its total capacity or service, in the event that approval from the MII for permanent use of such spectrum is not obtained. When necessary, CTHK may also apply to the MII for additional spectrum allocation.

CTHK also has been given permission to use 10 MHz of spectrum in the 1800 MHz frequency band for an indefinite term in each of Guangdong, Zhejiang and Jiangsu, which was allocated to the DGT by the former SRRC in December 1996. CTHK has used such spectrum to introduce DCS 1800 systems to expand the capacity of its GSM networks by adding cell sites in certain areas with a high-density of cellular subscribers.

### ***Base Station Sites***

In urban areas, CTHK's base transceiver station sites are located mostly on existing structures, typically at the top of tall buildings. In rural areas, masts are often constructed for locating base transceiver stations. Of CTHK's 10,199 total base transceiver stations as of December 31, 1998, approximately 38.4%, 25.1% and 36.5% were in Guangdong, Zhejiang and Jiangsu, respectively. Typically, such properties are of limited size, as base transceiver station equipment does not generally require significant space. Generally, depending on the length of time required for negotiation with respect to use of the land or buildings, construction of a base transceiver station takes approximately one to three months in an urban area and approximately three to six months in a rural area. CTHK anticipates that it will need a significant number of new sites in connection with the expansion of its cellular networks. However, there can be no assurance that CTHK will be able to obtain the requisite number of sites on reasonable commercial terms.

### ***Equipment Suppliers***

CTHK selects its principal suppliers from among leading international manufacturers of cellular equipment and in accordance with technical standards set by the MII. CTHK's TACS networks use equipment primarily supplied by Ericsson and Motorola, while its GSM networks use equipment primarily supplied by Ericsson, Motorola, Nokia and Alcatel. CTHK's largest supplier accounted for approximately 35% of CTHK's network equipment purchases in 1998, and the top five suppliers accounted for an aggregate of 70% of CTHK's network equipment purchases in 1998.

### **Competition**

CTHK was the only provider of commercial cellular network services in Guangdong, Zhejiang and Jiangsu until Unicom commenced operation of its GSM cellular networks in such provinces in July 1995, March 1997 and October 1996, respectively. Unicom was established pursuant to an approval of the State Council dated December 1993. Unicom is aggressively marketing its services in order to build its subscriber base, and is seeking to expand its network coverage and capacity. As investment in cellular networks is largely fixed cost investment, as opposed to variable cost investment, and tariffs are subject to regulations by government authorities, profitability in the cellular telephone industry is fundamentally driven by subscriber growth. CTHK believes that it has a significant advantage in the competition for subscribers due to its wider network coverage, high network performance standards, greater roaming capabilities, wide range of value added service features offered, and its relationship with the China Telecom system, which allows CTHK to market its services under the "China Telecom" brand name through an extensive network of distributors within the China Telecom system. However, there can be no assurance that the State Council will not approve additional cellular



service providers in the future that will compete with CTHK and, more generally, CTHK cannot predict what effect the restructuring of the telecommunications industry in mainland China will have on competition in the industry. However, CTHK believes that the introduction of orderly competition has had a positive impact on the market for cellular telecommunications services by stimulating network buildup and improvements in service quality, increasing awareness of cellular services among potential subscribers, and advancing the pace of the search for technical innovations and efficiency improvements.

In August 1995, the China Telecom system and China Electronics Systems Engineering Company initiated a joint project to explore the feasibility of deploying 800 MHz CDMA technology in public cellular networks in mainland China (the "CDMA project"). The MII has undertaken to CTHK Limited that the China Telecom system will not participate, directly or indirectly, in the provision of cellular services in any province in which CTHK currently operates or may operate in the future. In connection therewith, the MII has undertaken to contribute to CTHK, at CTHK's option, the entire interest, if any, held by the China Telecom system in the CDMA project in any such province when and if the CDMA project, after trial operations, becomes commercially feasible.

CTHK also faces indirect competition from providers of other wireless communications services, such as paging. Although these services offer substantially lower prices for services, CTHK does not believe that such services constitute significant competition, as they provide a much more limited range of services compared to cellular telecommunications services.

CTHK's operations, along with those of other cellular network operators, are subject to a high degree of regulation by the MII. See "—Regulation". The MII has undertaken to CTHK that, to the extent within its power, CTHK and its subsidiaries will be treated equally with all other cellular telephone operators in respect of all approvals, transactions and arrangements between CTHK and its subsidiaries, on the one hand, and entities within the China Telecom system, on the other hand.

## **Regulation**

The cellular telecommunications industry is subject to a high degree of regulation by the government. Regulations issued or implemented by the State Council, the MII and other relevant government authorities, including the Ministry of Foreign Trade and Economic Cooperation (the "MOFTEC") and the SDPC, encompass virtually every aspect of cellular network operations, including entry into the telecommunications industry, scope of permissible business, interconnection and transmission line arrangements, technology and equipment standards, tariff policy, capital investment priorities, foreign investment and spectrum allocation.

The MII, under the leadership of the State Council, is responsible for formulating overall industry policy and regulations, coordinating telecommunications projects and networks at the national level, enforcing industry standards, and in general, supervising the operations of telecommunications service providers and managing the day-to-day administration of the national telecommunications sector. Under the control of the MII, there are 33 provincial level PTAs and over 2,385 PTBs at the municipal and county levels. The PTAs exercise regulatory responsibility over the telecommunications industry in their respective provinces.

In order to provide a uniform regulatory framework to encourage the orderly development of the telecommunications industry, the MII, under the direction of the State Council, is currently preparing a draft of the Telecommunications Law. The draft law, when formulated, will be submitted to the National People's Congress for review and adoption. If and when the Telecommunications Law is adopted by the National People's Congress, it is expected to become the basic telecommunications statute and the legal source of telecommunications regulations in China. In addition, the MII is currently preparing a draft of the telecommunications market regulations (the "Regulations"), which will be subject to approval by the State Council. The Regulations are expected to provide and clarify the regulatory rules and guidelines for the telecommunications industry in the interim prior to the adoption of the Telecommunications Law. Although CTHK expects that the Telecommunications Law and the Regulations would have a positive effect on the overall development of the telecommunications industry in mainland China, the nature and

scope of regulation envisaged by the Telecommunications Law and the Regulations are not fully known. There can be no assurance that the Telecommunications Law or the Regulations, if adopted, would not have a material adverse effect on CTHK's business, financial condition and results of operations.

Pursuant to the State Council document approving the IPO Restructuring and the IPO of CTHK Limited, the MII adopted guidelines (the "Guidelines") to regulate the domestic operations of the subsidiaries of CTHK Limited in mainland China. The Guidelines provide, among other things, that the existing regulatory framework governing state-owned telecommunications companies in mainland China also applies with equal effect to the subsidiaries of CTHK Limited.

### ***Entry into the Industry***

Until 1993, telecommunications regulations and policies in mainland China did not permit entities outside of the China Telecom system to engage in public telecommunications operations in mainland China. In August 1993, the Government opened certain non-basic sectors of the telecommunications industry, such as paging, to Chinese entities not affiliated with the former MPT. Cellular network operators and providers of basic telecommunications services, such as local and long distance fixed line telephone services, must receive specific approval from the State Council in order to provide such services. Currently, in addition to CTHK and entities within the China Telecom system, the State Council has granted approval to Unicom to provide, among others, cellular services.

Current regulations in mainland China prohibit foreign-invested enterprises and foreign individuals from owning, operating or participating in the operation of telecommunications services in mainland China without approval from the State Council. CTHK was granted special authorization from the State Council to effect the IPO Restructuring and the IPO.

### ***Spectrum Usage***

The Radio Administration Regulations, effective on September 11, 1993, promulgated pursuant to a joint statement issued by the State Council and the China Central Military Commission, empowers the former SRRC, under the joint leadership of the State Council and the China Central Military Commission, to undertake the centralized regulation of all radio frequencies. As part of the government restructuring approved by the NPC in March 1998, the MII has assumed all the government functions of the former SRRC. In coordination with the relevant provincial PTAs, the MII allocates frequency, including the 900 MHz and the 1800 MHz frequency bands (which are reserved for mobile cellular applications). The frequency assigned to an entity is not allowed to be leased, or, without approval of the MII, transferred by the entity. Pursuant to a joint circular from the SDPC and the Ministry of Finance, effective May 1, 1997, the DGT determines the amount of fees to be paid to the MII for spectrum usage by each cellular network operator under the MII's control based on bandwidth of the frequency used and the number of base transceiver stations within the operator's network, subject to the limitation that the total annual payment by all such operators in mainland China shall equal RMB 1.0 million per MHz of frequency allocated by the MII.

### ***Tariff Setting***

CTHK's tariffs are subject to regulation by various Government authorities, including the SDPC, the MII, the relevant price regulatory authorities and the relevant PTAs. The connection fee is based on a guidance price range set jointly by the MII and the SDPC, with the actual tariff determined by the relevant PTAs in consultation with the relevant price regulatory authorities. In general, base usage charges, monthly fees, domestic roaming usage charges and tariffs for all long distance and international calls are fixed jointly by the MII and the SDPC. International roaming charges are set pursuant to agreements between the DGT and the relevant foreign cellular operators.

### ***Interconnection Arrangements***

Cellular networks must interconnect with the China Telecom system's PSTN to enable subscribers to a cellular network to communicate with fixed line subscribers and subscribers to other cellular networks and to make and receive domestic and international long distance calls. The MII is responsible for approving applications for interconnection with the PSTN and for designing and regulating technical plans for the interconnection, while the DGT is responsible for implementing such plans. The applicable regulations provide that switching, transmission and other equipment must conform with the technical standards approved by the MII. See "— Technical Standards". The MII also determines the amounts of lease payments to be collected by the PTAs, which operate the PSTN, with respect to leasing of transmission lines that facilitate interconnection to be made between cellular networks and the PSTN. The PTAs and PTBs are responsible for the maintenance of the transmission lines and related equipment.

### ***Technical Standards***

The MII sets technical standards and controls the type of cellular equipment used in public networks by requiring all network operators within the China Telecom system to purchase their equipment from suppliers who have obtained prior certification from the MII. In addition, the Provisions on the Management of Import of Radio Transmission Equipment, jointly issued by the former SRRC, the State Economics and Trade Commission (the "SETC"), the MOFTEC and the Customs General Administration, effective January 1, 1996, provides that before radio transmission equipment (including cellular equipment) may be imported into mainland China, an importer must obtain the necessary certification from the MII and the State Mechanical and Electrical Products Import and Export Office under the SETC.

To ensure the quality of interconnection and integration of cellular networks with the PSTN, applicable regulations provide that a network access permit must be obtained from the MII with respect to each specific type of terminal equipment to be used for interconnection, whether such equipment is imported or manufactured domestically.

### ***Capital Investment***

The SDPC is empowered by the State Council to exercise responsibility over the approval of all major investment projects, including cellular network development projects, involving total capital investment between RMB 50 million and RMB 500 million. Any investment projects with total capital investment in excess of RMB 500 million must obtain approval from the State Council. Accordingly, project proposals and feasibility study reports for such projects, following review and approval by the MII or the relevant PTAs, are required to be submitted for approval to the SDPC or its relevant provincial bureau, or the State Council. The establishment of each base transceiver station also requires approval of the relevant provincial PTAs. Certain of such approvals are currently pending. CTHK has not experienced and does not expect to experience difficulty in obtaining permission to establish additional sites.

### **Employees**

As of December 31, 1998, CTHK had 12,530 employees, including 12,509 employees in Guangdong, Zhejiang and Jiangsu, as classified in the following table, and 21 employees in Hong Kong. Approximately 40% of CTHK's

permanent employees have college or graduate degrees.

	<u>Guangdong</u>	<u>Zhejiang</u>	<u>Jiangsu</u>
Management . . . . .	1,352	490	505
Technical and engineering . . . . .	3,108	926	892
Sales and marketing . . . . .	2,643	843	1,011
Financial and accounting . . . . .	<u>343</u>	<u>201</u>	<u>195</u>
Total . . . . .	7446 <sup>(1)</sup>	2460 <sup>(2)</sup>	2,603

(1) Includes 1,456 temporary employees.

(2) Includes 211 temporary employees.

CTHK provides benefits to certain of its employees, including housing, retirement benefits and hospital, maternity, disability and dependent medical care benefits. Most CTHK employees are members of a labor association. CTHK has not experienced any strikes, slowdowns or labor disputes that have interfered with its operations, and CTHK believes that its relations with its employees are good.

**Item 2. Description of Property.**

CTHK's principal executive offices are located in Hong Kong, and are sub-leased from Telpo Communications (Group) Limited, an affiliate of the Company, pursuant to a tenancy agreement which will expire on June 30, 2000. CTHK's regional headquarters are located in Guangzhou, Hangzhou and Nanjing. CTHK has interests in various properties which consist of land and buildings for offices, administrative centers, staff quarters, retail outlets and technical facilities. CTHK is in the process of obtaining land use right certificates and property title certificates for certain of these properties in Guangdong and Jiangsu. CTHK believes that its use of these properties are not affected by the fact that it has not yet obtained the relevant land use right certificates and property title certificates. China Telecom (Hong Kong) Group Limited, the indirect controlling shareholder of CTHK Limited, has agreed to indemnify CTHK against any loss or damage caused by or arising from any challenge of, or interference with, CTHK's right to use these properties.

CTHK also leases various offices, administrative centers, staff quarters, retail outlets and technical facilities in mainland China and Hong Kong. In addition, CTHK leases from the Guangdong, Zhejiang and Jiangsu PTAs or otherwise has the right to use various properties for cell sites and switching equipment. CTHK believes that all of its owned and leased properties are well maintained and are suitable and adequate for their present use.

**Item 3. Legal Proceedings.**

CTHK is not involved in any litigation, arbitration or administrative proceedings relating to claims which could have a significant effect on the results of operation and financial condition of CTHK taken as a whole, and, so far as CTHK is aware, no such litigation, arbitration or administrative proceedings are pending or threatened.

#### Item 4. Control of Registrant.

As of December 31, 1998, approximately 76.5% of CTHK Limited's outstanding shares were held by China Telecom Hong Kong (BVI) Limited, a wholly-owned subsidiary of China Telecom (Hong Kong) Group Limited, which in turn is indirectly controlled by the MII. Accordingly, CTHK Limited is indirectly controlled by the MII, a government ministry under the leadership of the State Council.

The following table sets forth certain information regarding ownership of the CTHK Limited's capital stock as of December 31, 1998 by all persons who own more than ten percent (10%) of the ordinary shares, par value HK\$0.10 per share, of CTHK Limited.

<u>Shareholder</u>	<u>Number of Ordinary Shares Owned</u>	<u>Percentage of Outstanding Ordinary Shares</u>
China Telecom Hong Kong (BVI) Limited . . . . .	9,010,000,000	76.5%

As of December 31, 1998, the directors and executive officers of CTHK Limited beneficially owned an aggregate of 2,000 ordinary shares. CTHK Limited is not aware of any arrangement which may at a subsequent date result in a change of control of CTHK Limited.

#### Item 5. Nature of Trading Market.

In connection with its IPO, CTHK Limited's American depositary shares (the "ADSs"), each representing 20 ordinary shares, were listed and commenced trading on the New York Stock Exchange (the "NYSE") on October 22, 1997 under the symbol "CHL". The ordinary shares were listed and commenced trading on the Hong Kong Stock Exchange on October 23, 1997. Prior to such listings, there was no public market for CTHK Limited's equity securities. The NYSE and the Hong Kong Stock Exchange are the principal trading markets for CTHK Limited's ADSs and ordinary shares, which are not listed on any other exchanges in or outside the United States.

As of December 31, 1998, there were 11,780,788,000 ordinary shares issued and outstanding. As of December 31, 1998, there were 101 registered holders of American depositary receipts evidencing 4,873,620 ADSs. Since certain of the ADSs are held by nominees, the above number is not representative of the actual number of U.S. beneficial holders of ADSs or the number of ADSs beneficially held by U.S. persons. The depositary of the ADSs is The Bank of New York.

The high and low sale prices for shares of the ordinary shares on the Hong Kong Stock Exchange and of the ADSs on the NYSE for each full quarterly period since listing, are as follows:

	<u>Price per Share (HK\$)</u>		<u>Price per ADS (US\$)</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
<b>1997</b>				
Fourth Quarter . . . . .	14.40	10.55	38.25	26.38
<b>1998</b>				

First Quarter . . . . .	16.25	10.30	42.75	26.50
Second Quarter . . . . .	16.55	11.15	41.94	30.00
Third Quarter . . . . .	14.10	8.75	36.13	22.06
Fourth Quarter . . . . .	15.95	11.60	40.94	28.63
<b>1999</b>				
First Quarter . . . . .	15.80	12.55	41.38	32.25

## **Item 6. Exchange Controls and Other Limitations Affecting Security-Holders.**

There are no limitations on the right of non-resident or foreign owners to remit dividends or to hold or vote the ordinary shares or the ADSs imposed by Hong Kong law or by the memorandum and articles of association or other constituent documents of CTHK Limited.

## **Item 7. Taxation.**

The taxation of income and capital gains of holders of ordinary shares or ADSs is subject to the laws and practices of Hong Kong and of jurisdictions in which holders of ordinary shares or ADSs are resident or otherwise subject to tax. The following summary of certain relevant taxation provisions under Hong Kong law is based on current law and practice, is subject to changes therein and does not constitute legal or tax advice. The discussion does not deal with all possible tax consequences relating to an investment in the ordinary shares or ADSs. Accordingly, each prospective investor (particularly those subject to special tax rules, such as banks, dealers, insurance companies, tax-exempt entities and holders of 10% or more of CTHK Limited's voting capital stock) should consult its own tax adviser regarding the tax consequences of an investment in the ordinary shares and ADSs. The discussion is based upon laws and relevant interpretations thereof in effect as of the date of this annual report, all of which are subject to change. There is no reciprocal tax treaty in effect between Hong Kong and the United States.

### **Tax on Dividends**

Under the current practices of the Hong Kong Inland Revenue Department, no tax is payable in Hong Kong in respect of dividends paid by CTHK Limited unless such dividends are attributable to a trade, profession or business carried on in Hong Kong.

### **Profits Tax**

No tax is imposed in Hong Kong in respect of capital gains from the sale of property (such as the ordinary shares and ADSs). Trading gains from the sale of property by persons carrying on a trade, profession or business in Hong Kong where such gains are derived from or arise in Hong Kong from such trade, profession or business will be chargeable to Hong Kong profits tax which is currently imposed at the rate of 16% on corporations and at a maximum rate of 15% on individuals. Gains from sales of the ordinary shares effected on the Hong Kong Stock Exchange may be considered to be derived from or arise in Hong Kong. Liability for Hong Kong profits tax may thus arise in respect of trading gains from sales of ordinary shares or ADSs realized by persons carrying on a business or trading or dealing in securities in Hong Kong.

### **Stamp Duty**

Hong Kong stamp duty, currently charged at the rate of HK\$1.25 per HK\$1,000 or part thereof on the higher of the consideration for or the value of the ordinary shares, will be payable by the purchaser on every purchase and by the seller on every sale of ordinary shares (i.e., a total of HK\$2.50 per HK\$1,000 or part thereof is currently payable on a typical sale and purchase transaction involving ordinary shares). In addition, a fixed duty of HK\$5 is currently payable on any instrument of transfer of ordinary shares. The withdrawal of ordinary shares upon the surrender of ADSs, and the issuance of ADSs upon the deposit of ordinary shares, will also attract stamp duty at the rate described above for sale and purchase transactions unless the withdrawal or deposit does not result in a change in the beneficial ownership of the ordinary shares under Hong Kong law, in which case only a fixed duty of HK\$5 is payable on the transfer. The issuance of the ADSs upon the deposit of ordinary shares issued directly to the depository or for the account of the depository does not attract stamp duty. No Hong Kong stamp duty is payable upon the transfer of ADSs outside Hong Kong.

### **Estate Duty**

The ordinary shares are Hong Kong property under Hong Kong law, and accordingly such ordinary shares may be subject to estate duty on the death of the beneficial owner of such ordinary shares (regardless of the place of the owner's residence, citizenship or domicile). Hong Kong estate duty is imposed on a progressive scale from 5% to 15%. The rate of and the threshold for estate duty has, in the past, been adjusted on a fairly regular basis. No estate duty is payable when the aggregate value of the dutiable estate does not exceed HK\$7.5 million, and the maximum rate of duty of 15% applies when the aggregate value of the dutiable estate exceeds HK\$10.5 million.

## **Item 8. Selected Financial Data.**

### **Selected Financial Information**

The following tables present selected historical financial data of CTHK as of and for each of the years in the five-year period ended December 31, 1998. The selected historical income statement data for the years ended December 31, 1996, 1997 and 1998 and the selected historical balance sheet data as of December 31, 1997 and 1998 set forth below are derived from, and should be read in conjunction with, and are qualified in their entirety by reference to, the audited consolidated financial statements of CTHK, including the notes thereto, included elsewhere in this annual report. The selected historical Hong Kong GAAP income statement data for the years ended December 31, 1994 and 1995 and the selected historical Hong Kong GAAP balance sheet data as of December 31, 1995 and 1996 are derived from audited financial statements of CTHK that are not included herein. The selected historical Hong Kong GAAP balance sheet data as of December 31, 1994, the selected historical US GAAP income statement data for the year ended December 31, 1995, and the selected historical US GAAP balance sheet data as of December 31, 1995 and 1996 set forth below are unaudited, but, in the opinion of CTHK Limited, reflect the adjustments necessary for a fair presentation of such data.

The consolidated financial statements of CTHK are prepared and presented in accordance with Hong Kong GAAP. CTHK has adopted the acquisition method to account for the acquisition of Jiangsu Mobile under Hong Kong GAAP. Accordingly, the consolidated financial statements include the results of Jiangsu Mobile for the period from June 4, 1998, the date of the acquisition, to December 31, 1998. In contrast, under US GAAP, the acquisition of Jiangsu Mobile is considered a combination of entities under common control which would be accounted for under the “as if pooling-of-interests” method, whereby assets and liabilities are accounted for at historical cost and the accounts of previously separate companies for periods prior to the combination generally are restated on a combined basis. For a discussion of significant differences between Hong Kong GAAP and US GAAP as they relate to CTHK, and the effects of such differences on net profit for the years ended December 31, 1996, 1997 and 1998, and shareholders’ equity as of December 31, 1997 and 1998, see Note 24 to the consolidated financial statements. In addition, the condensed consolidated financial statements of CTHK prepared and presented in accordance with US GAAP for the relevant periods have been included in Note 24 to the consolidated financial statements.

In connection with the IPO Restructuring, CTHK entered into certain arrangements, some of which had material impact on CTHK’s financial results in 1998 and, to a lesser extent, in 1997. Such arrangements include (i) new agreements with respect to interconnection revenue and costs, including an adjustment to the risk sharing arrangement with the relevant PTAs for uncollectible subscriber receivables for DDD and IDD calls, (ii) a new leased line agreement in Guangdong, (iii) an agreement with the Guangdong PTA allowing CTHK to retain certain local network service charge revenues, (iv) new service agreements, (v) a change in the tax treatment of connection fees and certain surcharge revenue for CTHK’s services and (vi) the revaluation of fixed assets as of May 31, 1997. In addition, similar arrangements entered into by CTHK in connection with the acquisition of Jiangsu Mobile, including arrangements with respect to interconnection, certain property leasing, certain services, tax treatment of connection fees and certain surcharge revenues, and the revaluation of assets of Jiangsu Mobile as of December 31, 1997 had material impact on CTHK’s financial results in 1998. CTHK’s financial results reflect the impact of all such arrangements as of the respective dates they became effective. For a description of such arrangements, see “Item 9. Management’s Discussion and Analysis of Financial Condition and Results of Operations—IPO Restructuring and Other Recent Developments” and “Item 13. Interest of Management in Certain Transaction.”



As of or for the year ended December 31,

	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1998</u>
	RMB	RMB	RMB	RMB	RMB	US\$
(in millions, except per share and per ADS information)						
Income Statement Data:						
<b>Hong Kong GAAP</b>						
Operating revenue .....	4,590.3	7,598.1	10,367.2	15,487.8	26,345.4	3,182.3
Operating expenses .....	1,614.8	2,856.2	5,404.8	10,073.6	18,692.9	2,258.0
Operating profit .....	2,975.6	4,741.9	4,962.4	5,414.2	7,652.5	924.4
Profit before tax and minority interests .....	3,021.1	4,954.3	4,940.8	5,953.3	9,386.5	1,133.8
Income tax .....	201.5	285.7	427.5	991.0	2,486.0	300.3
Net profit .....	2,819.6	4,668.6	4,509.2	4,955.4	6,899.8	833.4
Basic and diluted net profit per share(1)			0.50	0.52	0.59	0.07
Basic and diluted net profit per ADS(1) ..			10.02	10.39	11.71	1.41
<b>US GAAP(2)</b>						
Operating revenue .....		8,986.6	12,514.8	19,122.3	28,527.7	3,445.9
Operating expenses .....		3,434.5	6,699.1	12,171.4	19,184.7	2,317.4
Operating profit .....		5,543.9	5,815.7	6,951.0	9,343.0	1,128.6
Profit before tax and minority interests .....		5,775.0	5,939.2	7,518.7	11,181.1	1,350.6
Income tax .....		414.1	668.2	1,186.9	2,901.5	350.5
Net profit .....		5,369.1	5,266.9	6,324.9	8,278.9	1,000.0
Basic and diluted net profit per share(1)		0.60	0.58	0.65	0.70	0.09
Basic and diluted net profit per ADS(1) ..		11.92	11.69	13.27	14.05	1.70
<b>Balance Sheet Data:</b>						
<b>Hong Kong GAAP</b>						
Current assets						
Cash and cash equivalents .....	2,314.0	3,127.6	2,976.2	40,070.7	18,792.4	2,270.0
Accounts receivable .....	610.4	807.3	1,087.4	1,591.9	2,481.7	299.8
Fixed assets .....	3,828.5	7,345.8	11,536.0	18,634.2	33,986.3	4,105.3
Total assets .....	8,672.2	13,562.8	18,135.7	64,950.1	64,542.0	7,796.2
Short-term bank and other loans .....	377.5	512.8	1,504.3	2,147.6	5,337.4	644.7
Long-term bank and other loans .....	1,118.3	2,004.0	1,946.4	2,870.3	991.2	119.7
Total liabilities .....	3,624.0	4,522.1	5,657.3	10,386.2	18,699.3	2,258.7
Shareholders' equity .....	5,048.2	9,040.7	12,471.1	54,549.7	45,842.8	5,537.4
<b>US GAAP(2)</b>						
Fixed assets .....		8,731.4	15,545.7	20,793.5	29,516.7	3,565.4
Total assets .....		15,478.2	23,284.2	70,284.2	62,027.3	7,492.4
Long-term bank and other loans .....		2,012.9	2,053.8	3,023.4	991.2	119.7
Shareholders' equity .....		10,530.2	16,883.7	59,010.3	43,202.5	5,218.5

As of or for the year ended December 31,

	1994	1995	1996	1997	1998	1998
	RMB	RMB	RMB	RMB	RMB	US\$
(in millions, except per share and per ADS information)						
<b>Other Financial Data:</b>						
<b>Hong Kong GAAP</b>						
Capital expenditures .....	2,284.0	2,652.5	5,510.9	5,806.8	11,040.3	1,333.6
Operating cash flow(3) .....	3,400.2	4,450.3	4,213.3	8,203.0	13,444.0	1,623.9
EBITDA(4) .....	3,372.6	5,707.0	6,435.7	8,179.7	12,586.6	1,520.4
<b>US GAAP(2)</b>						
Operating cash flow .....		6,118.8	6,637.9	10,467.3	14,273.3	1,623.9

- (1) The basic and diluted net profit per share and per ADS amounts under Hong Kong GAAP and under US GAAP for the years ended December 31, 1995, 1996, 1997 and 1998 have been computed by dividing net profit under Hong Kong GAAP and US GAAP, respectively, by the weighted average number of shares and the weighted average number of ADSs outstanding as if 9,010,000,000 ordinary shares and 450,500,000 ADSs (based on a ratio of 20 Shares to one ADS) issued in the IPO Restructuring were outstanding for the years shown. (See (2) below)
- (2) The amounts for the years ended December 31, 1995, 1996, 1997 and 1998 are presented to reflect the acquisition of Jiangsu Mobile under the "as if pooling-of-interest" method, as well as the effects of other differences between HK GAAP and US GAAP..
- (3) Net cash inflows from operating activities less net cash outflows (inflows) from returns on investments and servicing of finance and taxation.
- (4) EBITDA represents earnings before interest income, interest expense, non-operating income (expense), income taxes, depreciation and amortization. EBITDA is commonly used in the telecommunications industry to analyze companies on the basis of operating performance, leverage and liquidity. EBITDA is not intended to represent cash flow for the period nor has it been presented as an alternative to net profit as an indicator of operating performance. The items of net profit excluded from EBITDA are significant components in understanding and assessing CTHK's financial performance, and CTHK's computation of EBITDA may not be comparable to other similarly titled measures of other companies. See "Item 9. Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated statements of cash flows of CTHK contained elsewhere in this annual report.

### Exchange Rate Information

#### *China*

The following table sets forth certain information concerning exchange rates between Renminbi and US dollars for the periods indicated:

Period	Noon Buying Rate			
	Period End	Average*	High	Low
(RMB per US\$1)				
1994 .....	8.4662	8.6303	8.7409	8.4662
1995 .....	8.3374	8.3852	8.5000	8.2916
1996 .....	8.3284	8.3395	8.3549	8.3002
1997 .....	8.3100	8.3193	8.3290	8.2911
1998 .....	8.3008	8.2991	8.3100	8.2778

\* The average of the noon buying rates on the last day of each month during the relevant period.

## Hong Kong

The following table sets forth certain information regarding the exchange rates between Hong Kong dollars and US dollars for the periods indicated:

Period	Noon Buying Rate			
	<u>Period End</u>	<u>Average*</u>	<u>High</u>	<u>Low</u>
		(HK\$ per US\$1)		
1994 .....	7.7375	7.7284	7.7530	7.7225
1995 .....	7.7323	7.7354	7.7665	7.7300
1996 .....	7.7347	7.7341	7.7440	7.7310
1997 .....	7.7495	7.7440	7.7550	7.7275
1998 .....	7.7476	7.7465	7.7595	7.7355

\* The average of the noon buying rates on the last day of each month during the relevant period.

### Dividend Payments

The Board of Directors of CTHK Limited does not intend to recommend the payment of a dividend for the year ended December 31, 1998. As CTHK is experiencing a period of rapid growth, the Board deems it desirable that capital be retained for additional investment, network expansion and optimization, as well as potential acquisition of quality assets. CTHK Limited has not declared or paid any dividends since its incorporation in September 1997.

### Item 9. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion and analysis should be read in conjunction with the consolidated financial statements of CTHK, together with the notes thereto, included elsewhere in this annual report. The consolidated financial statements have been prepared in accordance with Hong Kong GAAP, which differ in certain significant respects from US GAAP. Note 24 to the consolidated financial statements summarizes the significant differences between Hong Kong GAAP and US GAAP as they relate to CTHK and provides a reconciliation to US GAAP of net profit and shareholders' equity. In addition, condensed consolidated financial statements of CTHK prepared and presented in accordance with US GAAP for the relevant periods have been included in Note 24 to the consolidated financial statements. The consolidated financial statements of CTHK present, and the discussion and analysis herein pertains to, the consolidated financial position and results of operations of CTHK Limited and its subsidiaries from the date of the IPO Restructuring or, in the case of Jiangsu Mobile, from June 4, 1998, the date of acquisition. The consolidated financial position and results of operations prior to September 27, 1997 represent the former combined operations of Guangdong Mobile and Zhejiang Mobile.

### Overview

During the three-year period ended December 31, 1998, CTHK's cellular network capacity, subscriber base and operations experienced significant growth. See "Item 1. Description of Business". CTHK believes that with the development of mainland China's economy and increases in per capita income, the telecommunications industry will continue to grow rapidly. In particular, CTHK expects that demand for cellular services will continue to grow as consumers increasingly value the convenience and quality of cellular telecommunications. Accordingly, CTHK believes that there is potential for significant future subscriber growth. CTHK intends to continue to focus on expanding its subscriber base in Guangdong, Zhejiang and Jiangsu and increasing subscriber usage by optimizing its network coverage and performance, expanding the range of value added services it offers to subscribers, increasing its marketing and distribution efforts and improving the quality of its services. CTHK believes that with its present network capacity and projected capacity increase pursuant to its network expansion plan,

as well as with its current significant market share, it is well positioned to take advantage of the anticipated growth in demand for cellular services in its markets.

Although CTHK's GSM cellular networks in Guangdong, Zhejiang and Jiangsu commenced operations in 1995, they have grown rapidly, accounting for 73% of CTHK's total subscribers as of December 31, 1998 and 83% of CTHK's total operating revenue during the year ended December 31, 1998. CTHK expects that, in the next few years, its GSM cellular operations will continue to grow at a faster rate than its TACS cellular operations as a result of subscriber preference for the wider range of functional capability and enhanced security of digital telecommunications, together with CTHK's emphasis on the development of its GSM cellular networks. See "Item 1. Description of Business — Operations — Network Capacity Expansion Plans".

CTHK's results of operations, like those of other cellular network operators, are substantially dependent on the number of subscribers, the level of subscriber usage, the level and structure of tariffs and interconnection and transmission line arrangements with other telecommunications operators. In addition, like other cellular network operators, CTHK operates in an extensively regulated environment and its operations and financial performance are significantly affected by the Government's regulation of, and policies regarding, the telecommunications industry and its restructuring, including with respect to interconnection and transmission line arrangements, technology and equipment standards, capital investment priorities and tariff structure. See "Item 1. Description of Business — Regulation". CTHK's financial performance is affected by a number of other variables external to CTHK and the telecommunications industry, such as economic and social conditions in mainland China and foreign currency exchange fluctuations.

#### **Acquisition of Jiangsu Mobile**

On June 4, 1998, CTHK Limited acquired Jiangsu Mobile. CTHK has adopted the acquisition method to account for the acquisition of Jiangsu Mobile under Hong Kong GAAP. Accordingly, the consolidated financial statements include the results of Jiangsu Mobile from June 4, 1998, the date of the acquisition. In contrast, under US GAAP, the acquisition of Jiangsu Mobile is considered a combination of entities under common control which would be accounted for under the "as if pooling-of-interests" method, whereby assets and liabilities are accounted for at historical cost and the accounts of previously separate companies for periods prior to the combination generally are restated on a combined basis. The acquisition of Jiangsu Mobile had a material impact on CTHK's overall results of operations for the year ended December 31, 1998. In particular, operating revenue and operating expenses (especially depreciation expenses) increased in 1998 as a result of the acquisition, while interest income and cash and cash equivalents decreased substantially following the acquisition as the payment of the cash consideration for the acquisition.

#### **IPO Restructuring and Other Recent Developments**

The current structure of CTHK was established pursuant to the IPO Restructuring completed in September 1997 and the acquisition of Jiangsu Mobile completed in June 1998. See "Item 1. Description of Business — History of CTHK". In connection with the IPO Restructuring, CTHK entered into certain arrangements to facilitate the transfer of the operations from the Guangdong PTA and the Zhejiang PTA to CTHK, to integrate such operations within CTHK and to improve CTHK's overall operational efficiency. Such arrangements included (i) new agreements with respect to interconnection revenue and costs, including an adjustment to the risk sharing arrangement with the relevant PTAs for uncollectible subscriber receivables for IDD and DDD calls, (ii) a new leased line agreement in Guangdong, (iii) an agreement with the Guangdong PTA allowing CTHK to retain certain local network service charge revenues, (iv) new service agreements, (v) a change in the tax treatment of connection fees and certain surcharge revenue for CTHK's services and (vi) the revaluation of fixed assets as of May 31, 1997. Certain similar arrangements were entered into in connection with the acquisition of Jiangsu Mobile, including arrangements with respect to interconnection, certain properties leasing, certain services, tax treatment of connection fees and certain surcharge revenues, and a revaluation of assets as of December 31, 1997. CTHK's financial results reflect the impact of such arrangements as of the dates they became effective. Such arrangements and changes have had a material impact on CTHK's overall results of operations. In particular, the implementation of new interconnection agreements in 1997 and 1998 led to significant increases in both operating revenue (in the form of usage fees and other operating revenues) and operating expenses (in the form of interconnection expenses). In addition, selling, general and administrative and other expenses increased as a

result of the implementation of agreements relating to billing and collection services and distribution and sales. Depreciation expense increased as a result of the revaluation of fixed assets in connection with the IPO Restructuring and the acquisition of Jiangsu Mobile, while income tax increased as a result of connection fees and certain surcharges becoming fully taxable following the IPO Restructuring.

### Geographical Markets

CTHK conducts its cellular operations in Guangdong, Zhejiang and Jiangsu. Launched approximately five years earlier than its cellular operations in Zhejiang and Jiangsu, CTHK's networks in Guangdong have greater capacity, serve the majority of CTHK's subscribers and account for the majority of CTHK's operating revenue and operating income. As of December 31, 1998, CTHK's subscribers in Guangdong, Zhejiang and Jiangsu represented 55.5%, 23.1% and 21.5% of total subscribers, respectively. During 1998, CTHK's operations in Guangdong, Zhejiang and Jiangsu accounted for 63.1%, 24.3% and 12.6% of CTHK's operating revenue and 66.3%, 24.5% and 10.2% of CTHK's operating profit, respectively. The following table sets forth certain financial information by geographical regions for 1996, 1997 and 1998:

	Year ended December 31,						
	1996		1997		1998		
	Guangdong Mobile	Zhejiang Mobile	Guangdong Mobile	Zhejiang Mobile	Guangdong Mobile	Zhejiang Mobile	Jiangsu Mobile
Operating revenue (RMB in millions) . . . . .	7,708.5	2,658.8	11,074.7	4,413.0	16,628.9	6,406.2	3,310.3
Operating margin . . . . .	45.5%	54.6%	36.6%	31.2%	30.5%	29.3%	23.6%
EBITDA margin . . . . .	59.9%	68.4%	53.8%	50.8%	46.8%	51.5%	48.0%

### Results of Operations

The following table sets forth selected statement of income data, expressed as percentages of operating revenue, for the periods indicated.

	<b>Year ended December 31,</b>		
	<b>1996</b>	<b>1997</b>	<b>1998</b>
Operating revenue: .....	100.0%	100.0%	100.0%
Usage fees .....	53.3	56.3	62.0
Monthly fees .....	16.0	17.4	16.5
Connection fees .....	25.8	20.5	12.6
Others .....	4.9	5.8	8.8
Operating expenses:			
Leased lines .....	21.4	20.2	14.9
Interconnection .....	1.9	7.8	18.0
Depreciation .....	13.7	17.3	17.5
Personnel .....	4.0	4.9	5.1
SG&A and others .....	11.1	14.8	15.5
Total operating expenses .....	<u>52.1</u>	<u>65.0</u>	<u>71.0</u>
Operating profit .....	47.9	35.0	29.0
Other income .....	0.5	0.5	1.3
Interest expense .....	(1.6)	(1.1)	(0.6)
Non-operating income (expenses) .....	<u>0.9</u>	<u>(0.2)</u>	<u>(0.2)</u>
Profit before exceptional item .....	47.7	34.2	29.5
Exceptional item .....	<u>—</u>	<u>4.2</u>	<u>6.1</u>
Profit before tax and minority interests .....	47.7	38.4	35.6
Income tax .....	<u>(4.1)</u>	<u>(6.4)</u>	<u>(9.4)</u>
Profit before minority interests .....	43.5	32.0	26.2
Minority interests .....	<u>—</u>	<u>—</u>	<u>—</u>
Net profit .....	<u>43.5%</u>	<u>32.0%</u>	<u>26.2%</u>

***Year Ended December 31, 1998 Compared to Year Ended December 31, 1997***

On June 4, 1998, CTHK Limited acquired Jiangsu Mobile. CTHK has adopted the acquisition method to account for the acquisition of Jiangsu Mobile under Hong Kong GAAP. Accordingly, the consolidated financial statements include the results of Jiangsu Mobile from June 4, 1998, the date of the acquisition. In addition, the various arrangements entered into by CTHK in connection with the IPO Restructuring had impact on CTHK's results of operation for the full year in 1998 as compared to less than three months in 1997. As a result, CTHK's results of operations for the year ended December 31, 1998 are not directly comparable with its results of operations for the year ended December 31, 1997.

***Operating Revenue.*** CTHK derives operating revenue principally from usage fees, monthly fees, and one-time connection fees charged to new subscribers. Usage fees represent standard local usage fee for airtime and, where applicable, DDD and IDD charges receivable from subscribers for the use of CTHK's cellular networks and facilities, revenue from the reseller agreements and fees in respect of roaming out calls made by CTHK's subscribers outside the registered service areas. CTHK also receives fees for other services it provides, including fees charged for certain value added services and telephone number selection and for roaming services provided to other cellular networks' subscribers.

Operating revenue increased from RMB 15,487.8 million in 1997 to RMB 26,345.4 million in 1998, due primarily to subscriber growth in Guangdong and Zhejiang and the addition of subscribers in Jiangsu, leading to increases in usage fees and monthly fees. Excluding Jiangsu Mobile, operating revenue increased 48.7% to RMB 23,035.1 million in 1998. CTHK's total number of subscribers increased 91.8% from 3.4 million at the end of 1997 to 6.5 million at the end of 1998. Excluding connection fees, operating revenue increased from RMB 12,314.3 million in 1997 to RMB 23,022.2 million in 1998.

Revenue from usage fees increased from RMB 8,718.1 million in 1997 to RMB 16,345.7 million in 1998. Excluding Jiangsu Mobile, usage fees increased 63.3% to RMB 14,238.2 million in 1998. The increase is due primarily to the increase in subscribers and the expanded communications opportunities for subscribers as a result of the expansion and improvement of fixed line and cellular networks throughout mainland China. In addition, as a result of the implementation of interconnection arrangements subsequent to the IPO Restructuring and the acquisition of Jiangsu Mobile, usage fees in 1998 included the full amount of revenues from IDD, DDD and roaming out calls, part of which were required to be settled with other network operators in accordance with the relevant agreements. As a percentage of operating revenue, usage fees increased from 56.3% in 1997 to 62.0% in 1998.

Revenue from monthly fees increased from RMB 2,692.2 million in 1997 to RMB 4,347.2 million in 1998, due to the increase in total subscribers. Excluding Jiangsu Mobile, monthly fees increased 46.4% to RMB 3,941.5 million in 1998, but replaced connection fees as the second largest component of operating revenue. As a percentage of operating revenue, monthly fees decreased from 17.4% in 1997 to 16.5% in 1998. CTHK expects that usage fees and monthly fees, which are related to its subscriber base and subscriber usage volume, will constitute an increasingly larger component of operating revenue. CTHK believes that this adjustment represents a more effective revenue structure and anticipates that it will lead to more reliable revenue growth in the long run.

Revenue from connection fees increased from RMB 3,173.5 million in 1997 to RMB 3,323.2 million in 1998, due to the increase in total subscribers. Excluding Jiangsu Mobile, connection fees decreased 8.7% to RMB 2,896.4 million in 1998 as a result of decreases in average connection fees charged to each new subscriber in Guangdong and Zhejiang. The average connection fee for each new subscriber decreased 28.8% from RMB 2,330 in 1997 to RMB 1,658 in 1998. CTHK believes that the reduction of connection fees for new subscribers may help to expand CTHK's subscriber base and result in increased total subscriber usage of CTHK's cellular services, and may reduce CTHK's reliance on connection fees to drive turnover growth. As a percentage of operating revenue, connection fees decreased from 20.5% in 1997 to 12.6% in 1998.

Other operating revenue increased by RMB 904.0 million in 1997 to RMB 2,329.3 million in 1998, reflecting primarily increases in revenue from fees charged to subscribers of other network operators for roaming-in within CTHK's service areas, revenues from interconnection settlement and fees charged to subscribers for value-added services. Excluding Jiangsu Mobile, other operating revenue increased 116.7% to RMB 1,959.0 million in 1998 as a result of the implementation of interconnection arrangements subsequent to the IPO Restructuring.

**Operating Expenses.** Operating expenses include principally leased line expenses, interconnection expenses, depreciation expense relating to CTHK's cellular network and other fixed assets, personnel expenses and selling, general and administrative ("SG&A") and other expenses, which primarily consist of selling and promotion expenses, network maintenance costs, provision for doubtful accounts, and operating lease charges.

Operating expenses increased from RMB 10,073.6 million in 1997 to RMB 18,692.9 million in 1998, due to higher leased line payments, interconnection expenses, depreciation charges, personnel expenses and SG&A and other expenses. Excluding Jiangsu Mobile, operating expenses increased 60.5% to RMB 16,164.5 million in 1998. Of the total increase in operating expenses, 9.1%, 41.1%, 22.2%, 6.7% and 20.9% was accounted for by the increase in leased line payments, interconnection expenses, depreciation charges, personnel expenses and SG&A and other expenses, respectively.

Total leased line payments increased from RMB 3,134.3 million in 1997 to RMB 3,917.4 million in 1998, due primarily to the acquisition of Jiangsu Mobile and network expansion to include new coverage areas, as well as to increased network transmission capacity within existing coverage areas. Excluding Jiangsu Mobile, leased line payments increased 3.4% to RMB 3,242.3 million in 1998. As a percentage of operating expenses, total leased line payments decreased from 31.1% in 1997 to 21.0% in 1998, reflecting greater efficiency in the utilization of leased lines and a decrease in leased line tariffs in Guangdong as a result of the implementation of the new leased line agreement in October 1997.

Interconnection expenses increased from RMB 1,214.2 million in 1997 to RMB 4,752.3 million in 1998, as a result of the implementation of new interconnection agreements in Guangdong and Zhejiang for the full year in 1998, compared to less than three months in 1997, as well as the implementation of a new interconnection agreement in Jiangsu from June 4 to December 31 in 1998 and the general increase in the volume of roaming out and inter-network traffic during 1998. Excluding Jiangsu

Mobile, interconnection expenses increased 248.6% to RMB 4,232.8 million in 1998. As a percentage of operating expenses, interconnection expenses increased from 12.1% in 1997 to 25.4% in 1998.

Depreciation expense increased from RMB 2,680.5 million in 1997 to RMB 4,598.2 million in 1998, primarily reflecting an increase in fixed assets as a result of the acquisition of Jiangsu Mobile, the full year depreciation in 1998 of assets of Guangdong Mobile and Zhejiang Mobile which were revalued as of May 1997 in connection with the IPO Restructuring, as well as increased capital expenditures made by CTHK to improve and expand its networks. Excluding Jiangsu Mobile, depreciation expenses increased 41.2% to RMB 3,783.8 million in 1998. As a percentage of operating expenses, depreciation expense decreased from 26.6% in 1997 to 24.6% in 1998.

Personnel expenses increased from RMB 755.5 million in 1997 to RMB 1,336.0 million in 1998, due primarily to the addition of employees in Jiangsu, the hiring of additional employees and the maintenance of a competitive salary package to retain experienced employees in 1998 to support network expansion and operation growth. Excluding Jiangsu Mobile, personnel expenses increased 55.6% to RMB 1,175.5 million in 1998. As a percentage of operating expenses, personnel expenses decreased slightly from 7.5% in 1997 to 7.1% in 1998.

SG&A and other operating expenses increased from RMB 2,289.0 million in 1997 to RMB 4,089.0 million in 1998, reflecting primarily a provision for diminution in value of part of the TACS-B network communications equipment of Zhejiang Mobile, and increases in selling and promotional expenses, network maintenance costs and provisions for doubtful accounts. Excluding Jiangsu Mobile, SG&A and other operating expenses increased 63.0% to RMB 3,730.2 million in 1998. The increase in selling and promotion expenses was due primarily to the addition of marketing and distribution operations in Jiangsu, as well as increased efforts on marketing and distribution in Guangdong and Zhejiang. Although provisions for doubtful accounts increased in 1998, as a percentage of operating revenue, provisions for doubtful accounts decreased from 2.9% in 1997 to 2.1% in 1998. In addition, as a percentage of recurring revenue (i.e. total operating revenue less connection fees) provisions for doubtful accounts have decreased from 3.6% in 1997 to 2.4% in 1998. These decreases were primarily attributable to measures implemented by CTHK to control doubtful debt risks and fraud, such as enhanced subscriber registration procedures, the imposition of credit limits for high usage subscribers, and tightened controls to improve timely payment by subscribers. See "Item 1. Description of Business — Operations — Customer Service and Billing".

**Operating Profit.** Operating profit increased from RMB 5,414.2 million in 1997 to RMB 7,652.5 million in 1998. Operating margin (operating profit as a percentage of operating revenue) declined from 35.0% to 29.0%, primarily due to increased operating expenses as a result of CTHK's network expansion and development, as well as changes implemented in connection with the IPO Restructuring and the acquisition of Jiangsu Mobile, coupled with slower growth in operating revenue resulting from tariff reductions (especially reductions in connection fees) and the addition of a larger number of subscribers with lower usage characteristics. Excluding Jiangsu Mobile, operating profit increased 26.9% to RMB 6,870.7 million in 1998, and operating margin declined 5.2 percentage points to 29.8%.

**EBITDA.** EBITDA represents earnings before interest income, interest expense, non-operating income (expenses), income taxes, depreciation and amortization. While EBITDA is commonly used in the telecommunications industry worldwide as an indicator of operating performance, leverage and liquidity, it is not presented as a measure of performance in accordance with generally accepted accounting principles and should not be considered as representing net cash flows from operating activities.

EBITDA increased from RMB 8,179.7 million in 1997 to RMB 12,586.6 million in 1998. EBITDA margin (EBITDA as a percentage of operating revenue) decreased from 52.8% in 1997 to 47.8% in 1998. Excluding Jiangsu Mobile, EBITDA increased 34.4% to RMB 10,997.4 million in 1998, and EBITDA margin decreased to 47.7% in 1998.

**Other Income; Non-operating Income/Expenses; Interest Expense; Exceptional Item.** Other income, which includes primarily gross profit from sales of SIM cards, handsets and accessories, increased from RMB 85.0 million in 1997 to RMB 335.9 million in 1998, reflecting primarily increased sales of SIM cards resulting from the increase in subscribers to CTHK's GSM networks and a decrease in the cost of SIM cards.



Non-operating expenses, which includes mainly net gains or losses on disposal of fixed assets and charitable donations, increased from RMB 27.1 million in 1997 to RMB 51.6 million in 1998.

Interest expense decreased from RMB 175.3 million in 1997 to RMB 159.8 million in 1998, primarily due to the repayment in 1998 of a portion of borrowings by CTHK and decreased borrowing as a result of the use of funds from the IPO of CTHK Limited to finance CTHK's capital requirements.

Profit before exceptional item increased from RMB 5,296.7 million in 1997 to RMB 7,777.1 million in 1998.

CTHK recorded an exceptional item of RMB 656.6 million in 1997 and RMB 1,609.4 million in 1998, representing primarily interest income earned by CTHK Limited from the proceeds received upon its IPO in October 1997.

Profit before tax and minority interests increased from RMB 5,953.3 million in 1997 to RMB 9,386.5 million in 1998.

**Taxation.** CTHK incurred income tax expense of RMB 991.0 million in 1997 and RMB 2,486.0 million in 1998, reflecting an effective tax rate of 16.6% and 26.5%, respectively. The increase in the effective tax rate was primarily due to the fact that connection fee revenue and certain surcharge revenue in Guangdong and Zhejiang were subject to taxation for the full year in 1998, compared to less than three months in 1997, as well as the taxation of similar revenue items in Jiangsu after it completed its registration in August 1998 as a wholly foreign owned enterprise as a result of its acquisition by CTHK.

**Net Profit.** Net profit increased from RMB 4,955.4 million in 1997 to RMB 6,899.8 million in 1998. Net profit margin (net profit as a percentage of operating revenue) decreased from 32.0% to 26.2%.

#### ***Year Ended December 31, 1997 Compared to Year Ended December 31, 1996***

**Operating Revenue.** Operating revenue increased 49.4% from RMB 10,367.2 million in 1996 to RMB 15,487.8 million in 1997, due primarily to subscriber growth, leading to increases in usage fees, monthly fees and connection fees. CTHK's total number of subscribers increased 66.7% from 2.04 million at the end of 1996 to 3.4 million at the end of 1997. Excluding connection fees, operating revenue increased 60.1% from RMB 7,693.8 million in 1996 to RMB 12,314.3 million in 1997. Average monthly revenue per subscriber (excluding connection fees) decreased 3.1% from RMB 389 in 1996 to RMB 377 in 1997, principally as a result of the expansion of CTHK's subscriber base to include a greater number of lower usage subscribers.

Revenue from usage fees increased 57.7% from RMB 5,527.9 million in 1996 to RMB 8,718.1 million in 1997, due primarily to the increase in subscribers and the expanded communications opportunities for subscribers. In addition, effective October 20, 1997, usage fees reflect primarily amounts billed to CTHK's subscribers, after deducting amounts payable by CTHK to the relevant PTAs as interconnection costs for certain calls which interconnect with the China Telecom system's PSTN. As a percentage of operating revenue, usage fees increased from 53.3% in 1996 to 56.3% in 1997.

Revenue from monthly fees increased 62.4% from RMB 1,658.2 million in 1996 to RMB 2,692.2 million in 1997, due to the increase in total subscribers. As a percentage of operating revenue, monthly fees increased from 16.0% in 1996 to 17.4% in 1997.

Revenue from connection fees increased 18.7% from RMB 2,673.4 million in 1996 to RMB 3,173.5 million in 1997, due to the increase in total subscribers. The average connection fee for each new subscriber decreased 31.4% from RMB 3,396 in 1996 to RMB 2,330 in 1997. As a percentage of operating revenue, connection fees decreased from 25.8% in 1996 to 20.5% in 1997.

Other operating revenue increased 78.0% from RMB 507.8 million in 1996 to RMB 904.0 million in 1997, reflecting increases in revenues from fees charged to subscribers of other network operators for roaming-in within CTHK's service areas, revenues from interconnection settlement and fees charged to subscribers for value-added services.

**Operating Expenses.** Operating expenses increased 86.4% from RMB 5,404.8 million in 1996 to RMB 10,073.6 million in 1997, due to higher leased line payments, interconnection expenses, depreciation charges, personnel expenses and

SG&A and other expenses. Of the total increase in operating expenses, 19.7%, 21.8%, 26.9%, 7.3% and 24.3% was accounted for by the increase in leased line payments, interconnection expenses, depreciation charges, personnel expenses and SG&A and other expenses, respectively.

Total leased line payments increased 41.6% from RMB 2,213.6 million in 1996 to RMB 3,134.3 million in 1997, due primarily to network expansion to include new coverage areas, as well as to increased network transmission capacity within existing coverage areas. As a percentage of operating expenses, leased line payments decreased from 41.0% in 1996 to 31.1% in 1997.

Interconnection expenses increased from RMB 196.4 million in 1996 to RMB 1,214.2 million in 1997, due primarily to amounts payable of approximately RMB 739 million to the Guangdong and Zhejiang PTAs as a result of the implementation of new interconnection agreements. As a percentage of operating expenses, interconnection expenses increased from 3.6% in 1996 to 12.1% in 1997.

Depreciation expense increased 88.2% from RMB 1,424.3 million in 1996 to RMB 2,680.5 million in 1997, primarily reflecting increased capital expenditures made by CTHK to improve and expand its networks, as well as the impact of the revaluation of CTHK's fixed assets as of May 31, 1997. As a percentage of operating expenses, depreciation expense was 26.4% in 1996 and 26.6% in 1997.

Personnel expenses increased 81.4% from RMB 416.5 million in 1996 to RMB 755.5 million in 1997, due primarily to the hiring of additional employees and the maintenance of a competitive salary package to retain experienced employees in 1997 to support network expansion and operation growth. As a percentage of operating expenses, personnel expenses were 7.7% in 1996 and 7.5% in 1997.

SG&A and other operating expenses increased 98.3% from RMB 1,154.1 million in 1996 to RMB 2,289.0 million in 1997, reflecting primarily increases of 43.6% in selling and promotion expenses, 70.8% in network maintenance costs and 97.5% in the provision for doubtful accounts. The increase in selling and promotion expenses was due primarily to CTHK's increased efforts on marketing and distribution, including a successful marketing program introduced during 1997 in Zhejiang that added approximately 130,000 new subscribers to Zhejiang Mobile's subscriber base. The increase in the provision for doubtful accounts in 1997 was primarily due to an increase in illegal cloning activities on CTHK's TACS network in 1997. As a percentage of operating revenue, provision for doubtful accounts increased from 2.2% in 1996 to 2.9% in 1997. CTHK has implemented a number of measures since 1997 to control and reduce the number of doubtful accounts. See "Item 1. Business — Operations — Customer Service and Billing".

**Operating Profit.** Operating profit increased 9.1% from RMB 4,962.4 million in 1996 to RMB 5,414.2 million in 1997. Operating margin declined from 47.9% to 35.0%, primarily due to increased expenses as a result of CTHK's network expansion and development, as well as changes implemented in connection with the IPO Restructuring.

**EBITDA.** EBITDA increased 27.1% from RMB 6,435.7 million in 1996 to RMB 8,179.7 million in 1997. EBITDA margin decreased from 62.1% in 1996 to 52.8% in 1997.

**Other Income; Non-operating Income/Expenses; Interest Expense; Exceptional Item.** Other income increased 73.5% from RMB 49.0 million in 1996 to RMB 85.0 million in 1997, reflecting primarily increased sales of SIM cards resulting from the increase in subscribers to CTHK's GSM networks.

Non-operating income/expenses changed from an income of RMB 96.5 million in 1996 to an expense of RMB 27.1 million in 1997, primarily as a result of the exchange loss primarily arising from the translation of CTHK Limited's financial statements from Hong Kong dollars to Renminbi.

Interest expense increased 4.9% from RMB 167.1 million in 1996 to RMB 175.3 million in 1997, primarily due to increased borrowing to finance CTHK's network expansion plan prior to the IPO of CTHK Limited.

Profit before exceptional item increased 7.2% from RMB 4,940.8 million in 1996 to RMB 5,296.7 million in 1997.

CTHK recorded an exceptional item of RMB 656.6 million in 1997, mainly representing interest income earned by CTHK Limited from the proceeds received upon its IPO.

Profit before tax and minority interests increased 20.5% from RMB 4,940.8 million in 1996 to RMB 5,953.3 million in 1997.

**Taxation.** CTHK incurred income tax expense of RMB 427.5 million in 1996 and RMB 991.0 million in 1997, reflecting an effective tax rate of 8.7% and 16.6%, respectively. The increase in the effective tax rate was primarily due to the fact that connection fee revenue and certain surcharge revenue became subject to taxation upon completion of the IPO of CTHK Limited.

**Net Profit.** Net profit increased 9.9% from RMB 4,509.2 million in 1996 to RMB 4,955.4 million in 1997. Net profit margin decreased from 43.5% to 32.0%.

### Liquidity and Capital Resources

Historically, CTHK's operations were directly or indirectly owned by or under the control of the relevant provincial PTAs, which constituted part of the China Telecom system. As a result, a significant portion of CTHK's working capital, capital expenditure and other capital requirements was subject to the requirements of, and managed pursuant to, the overall budgetary and other economic plans of the relevant PTAs. Pursuant to the IPO Restructuring, CTHK became a separate entity operationally and financially. As a result, CTHK needs to finance its various future capital requirements independently. The historical information contained herein concerning liquidity and capital resources of CTHK may not be indicative of the liquidity and capital resources of CTHK in the future or what the liquidity and capital resources will be or would have been had CTHK been a separate, stand-alone entity during the periods presented.

#### *Working Capital, Cash Flows and Financing*

As of December 31, 1998, CTHK had a working capital surplus (current assets minus current liabilities) of RMB 7,083.1 million and cash and cash equivalents of RMB 17,481.5 million, compared to RMB 36,468.1 million and RMB 40,070.7 million, respectively, as of December 31, 1997. The decreases in working capital and cash and cash equivalents were due primarily to the application during 1998 of the proceeds received from the IPO of CTHK Limited, including the use of such proceeds to fund the acquisition of Jiangsu Mobile and expansion and improvement of CTHK's networks. As of December 31, 1997 and 1998, accounts receivable totaled RMB 1,591.9 million and RMB 2,481.7 million, respectively. The increases in accounts receivable were primarily a result of increased sales of CTHK's services. Short-term and long-term bank and other loans totaled RMB 5,017.9 million and RMB 6,328.5 million as at December 31, 1997 and 1998, respectively.

	<u>Year ended December 31,</u>		
	<u>1996</u>	<u>1997</u>	<u>1998</u>
	(RMB in millions)		
Net cash inflows from operating activities . . . . .	6,418.4	8,825.5	13,566.8
Net cash outflow from returns on investments and servicing of finance and taxation . . . . .	(2,205.1)	(622.5)	(122.8)
Net cash outflow from investing activities . . . . .	<u>(5,263.6)</u>	<u>(5,327.1)</u>	<u>(36,357.0)</u>
Net cash inflow/(outflow) before financing activities . . . . .	(1,050.3)	2,876.0	(22,913.0)
Net cash inflow from financing activities . . . . .	<u>898.9</u>	<u>34,218.5</u>	<u>323.8</u>
Increase/(decrease) in cash and cash equivalents . . . . .	<u><u>(151.3)</u></u>	<u><u>37,094.4</u></u>	<u><u>(22,589.2)</u></u>

Net cash inflows from operating activities increased from 1996 to 1998, generally reflecting the growth in operating revenue due to the increase in CTHK's subscriber base.

Net cash outflow from returns on investments and servicing of finance and taxation decreased from 1996 to 1997 primarily due to decreases in distributions made by CTHK to the Guangdong PTA and the Zhejiang PTA following the IPO Restructuring and the IPO of CTHK Limited, and from 1997 to 1998 primarily due to an increase in interest received on the proceeds of the IPO, which more than offset a significant increase in Chinese income tax paid.

Net cash outflow from investing activities increased significantly from 1996 to 1998, primarily due to increased equipment purchases in connection with CTHK's network expansion, as well as the payment of the consideration for the acquisition of Jiangsu Mobile and an increase in deposits with banks in 1998.

Net cash inflow from financing activities reflects net borrowings or repayments of debt, but excludes credit extended to CTHK by equipment suppliers for additions to construction in progress. Net cash inflow from financing activities increased significantly in 1997 as a result of the IPO of CTHK Limited and decreased in 1998 as a result of repayments of bank and other loans.

As of December 31, 1998, CTHK's aggregate long-term bank and other loans totaled RMB 2,216.0 million. Scheduled amounts payable in 1999, 2000 and 2001 will be approximately RMB 1,224.9 million, RMB 284.8 million and RMB 284.8 million, respectively.

### ***Capital Expenditures***

Capital expenditures during 1996, 1997 and 1998 were RMB 5,777.9 million, RMB 8,719.1 million and RMB 15,030.2 million, respectively. Capital expenditures made by CTHK were principally for the development, optimization and expansion of its GSM networks and the further refinement of its TACS networks in Guangdong, Zhejiang and (after June 1998) Jiangsu.

CTHK anticipates that it will require approximately RMB 15,100 million (US\$1,824 million) in Guangdong, RMB 7,970 million (US\$963 million) in Zhejiang and RMB 7,340 million (US\$887 million) in Jiangsu to finance the planned expansion of its GSM networks and improvement of its TACS networks through the end of 2000, of which approximately RMB 6,250 million (US\$755 million), RMB 3,720 million (US\$449 million) and RMB 4,040 million (US\$488 million) is expected to be expended in Guangdong, Zhejiang and Jiangsu, respectively, in 1999. See "Item 1. Description of Business — Cellular Networks — Network Capacity Expansion Plans".

Prior to the IPO of CTHK Limited, CTHK relied on a combination of cash generated from operations, short-term and long-term bank and other borrowings (including borrowings from the Guangdong PTA and the Zhejiang PTA) and credit from equipment suppliers for its capital expenditures and other capital requirements. Following the IPO of CTHK Limited, CTHK has funded capital requirements primarily with the proceeds from such offering, cash generated from operations and, to the extent necessary, short-term borrowings. CTHK believes that cash in hand and cash generated from future operations, together with the proceeds from the IPO of CTHK Limited, will be sufficient to fund most of the capital expenditures and working capital necessary for the planned network expansion and continued growth of its cellular operations through the end of 2000. If necessary, CTHK may seek to obtain additional sources of financing to complete its network expansion.

### **Foreign Exchange**

CTHK maintains its accounts in Renminbi and substantially all of CTHK's revenue and expenses are denominated in Renminbi. CTHK's capital expenditures, which are principally denominated in U.S. dollars and incurred in connection with its purchase of imported equipment, totaled the equivalent of RMB 5,778 million, RMB 8,719 million and RMB 15,030 million, for 1996, 1997 and 1998, respectively. In addition, CTHK also incurs interest expense on foreign currency (mainly U.S. dollar) denominated borrowings. U.S. dollar denominated long-term loans (excluding current portions) totaled the equivalent of RMB 2,370.3 million and RMB 991.2 million at December 31, 1997 and 1998, respectively, constituting 82.6% and 100% of CTHK's total long-term loans (excluding current portions) in such year, respectively.

Under the current foreign exchange system in mainland China, CTHK Limited's subsidiaries may not be able to hedge effectively against currency risk, including possible future Renminbi devaluation. Although CTHK does not expect significant

currency risk given its current operating activities, there can be no assurance that any future movements in the exchange rate of the Renminbi against the U.S. dollar and other currencies will not adversely affect CTHK's results of operations and financial condition.

Guangdong Mobile, Zhejiang Mobile and Jiangsu Mobile are able to purchase foreign exchange for settlement of current account transactions, as defined in applicable regulations, in order to satisfy their foreign exchange requirements.

### **US GAAP Reconciliation**

The consolidated financial statements of CTHK are prepared in accordance with Hong Kong GAAP, which differ in certain significant respects from US GAAP. Under HK GAAP, the Group adopted the acquisition method to account for the purchase of Jiangsu Mobile. Under the acquisition method, the acquired results of Jiangsu Mobile were included in the results of operations from the date of its acquisition. Goodwill arising on the acquisition date, being the excess of the cost over the fair value of CTHK's share of the separable net assets acquired, was eliminated against reserves immediately on acquisition.

For US GAAP, as a result of both CTHK and Jiangsu Mobile being under common control prior to the acquisition, such acquisition under was considered a "combination of entities under common control". Under US GAAP, combinations of entities under common control are accounted for under the "as if pooling-of-interests" method, whereby assets and liabilities are accounted for at historical cost and the financial statements of previously separate companies for periods prior to the combination generally are restated on a combined basis. The cash consideration paid by CTHK has been treated as an equity transaction in the year of acquisition for US GAAP purposes.

In addition, there are other differences between HK GAAP and US GAAP that relate primarily to the computation of capitalized interest, the revaluation of fixed assets under Hong Kong GAAP, including the revaluation in connection with the IPO Restructuring and the acquisition of Jiangsu Mobile, the recognition of deferred income taxes, the non-recognition under Hong Kong GAAP of certain employee housing scheme costs not borne by CTHK and the treatment of share options granted by the Group to directors and employees. See Notes 24 and 25 to the consolidated financial statements.

The condensed consolidated balance sheets as of December 31, 1997 and 1998 and the condensed consolidated statements of income, total shareholders' equity and cash flows for the years ended December 31, 1996, 1997 and 1998 prepared and presented under US GAAP have been included in Note 24 to the consolidated financial statements to reflect the impact of the significant differences between Hong Kong GAAP and US GAAP.

### **Year 2000 Readiness Disclosure**

The "Year 2000 issue", which is common to most companies, concerns the improper storage and manipulation of date fields within software applications, systems, databases, and hardware. The issue arises as a result of computer programs being written and automated systems being designed by using two, rather than four, digits to represent the applicable year. As a result, any time-sensitive computer and automated system may recognize a date using "00" as the year 1900 rather than the year 2000, which could result in system failures. CTHK recognizes that if the issue is not resolved, it will affect the normal operations of CTHK's telecommunications and computer systems.

CTHK's aim is to modify or upgrade the time identification sections in its telecommunications network and computer systems to ensure that the telecommunications network works smoothly and the information management network and other electronic devices are protected from the Year 2000 issue. The ideal solution is to implement a four-digit decimal system to indicate the year on all applicable systems. If this proves to be difficult, CTHK will adopt a transitional method: using digits 80-99 to indicate the years 1980-1999 and 00-30 to indicate the years 2000-2030. CTHK will endeavor to make sure that systems using the transitional method and systems using other methods can exchange information correctly. All new equipment to be purchased by CTHK must meet these requirements and CTHK intends to remove any equipment that does not meet such requirements by the end of June 1999.

CTHK has set up a project team which is conducting a review of its computer systems to identify the potential impact of the Year 2000 issue. CTHK finished assessment of all equipment and other electronic devices between April and June 1998

and has identified those that are not Year 2000 compliant. CTHK's internal team of technicians and other experts have been upgrading certain of such electronic devices and equipment to ensure they are Year 2000 compliant. With respect to most of the equipment and major electronic devices that are not Year 2000 compliant, CTHK has been coordinating its remedial, upgrading and testing work with the relevant equipment suppliers. From June to August 1998, CTHK negotiated and signed contracts relating to its Year 2000 compliance program with equipment suppliers. Pursuant to these contracts, the suppliers are responsible for upgrading or modifying the necessary equipment components. CTHK's telecommunications equipment suppliers have undertaken to CTHK that they are capable of and responsible for resolving any Year 2000 issue as it relates to CTHK's telecommunications network. CTHK's suppliers of computer equipment have also undertaken to resolve any Year 2000 issue as it may relate to such equipment. Modification and upgrading of relevant equipment commenced in August 1998 and is expected to be completed by the end of June 1999. Testing and verification of equipment is expected to commence in July 1999 in order to allow sufficient time to monitor the equipment's operating performance and detect and resolve any potential problems.

CTHK has been closely following the progress of the relevant suppliers in resolving any Year 2000 issue in relation to CTHK's equipment. However, given CTHK's need to rely on information obtained from third parties and the difficulty of determining potential errors, no assurance can be given that the network and systems of CTHK will not be adversely affected by mistakes, if any, of third parties or by any failures of such third parties to complete their Year 2000 undertakings on a timely basis. If CTHK's anticipated modifications and corrections are not completed on a timely basis, or if the systems of such third parties on which the operations of CTHK rely are not modified or corrected on a timely basis, the Year 2000 issue could have a material adverse effect on CTHK's operation and financial results.

On December 31, 1998, CTHK announced an estimated total budget of approximately US\$30 million to address the Year 2000 issue, approximately 20% of which had already been incurred in 1998 and prior years and was recognized as an expense. By December 31, 1998, the Group had executed contracts relating to the Year 2000 compliance program with a total value of US\$18.0 million. The estimated budget may be revised should problems occur from outside sources or due to unforeseen circumstances and there can be no assurance that the actual costs required for addressing the Year 2000 issue will not exceed the estimated level.

CTHK recognizes the importance of readiness for potential worst case scenarios. Emergency procedures have been formulated to prepare CTHK for system failures caused by the Year 2000 issue. Testing for these emergency procedures is scheduled to take place in the second half of 1999.

#### **Item 9A. Quantitative and Qualitative Disclosures About Market Risk.**

CTHK is subject to market rate risks due to fluctuations in interest rates. The majority of CTHK's debt is in the form of long-term, fixed- and variable-rate bank and other loans with original maturities ranging from one to six years. Accordingly, fluctuations in interest rates can lead to significant fluctuations in the fair value of such debt instruments. From time to time, CTHK may enter into interest rate swap agreements designed to mitigate its exposure to interest rate risks. CTHK did not engage in any interest rate hedging activity in 1998.

CTHK is also exposed to foreign currency risk as a result of its telecommunications equipment being sourced substantially from overseas suppliers. Specifically, CTHK's foreign currency exposure relates primarily to its foreign currency denominated short- and long-term debt, its firm purchase commitments and, to a limited extent, cash and cash equivalents denominated in foreign currencies. CTHK may, from time to time, enter into currency swap agreements and foreign exchange forward contracts designed to mitigate its exposure to foreign currency risks. Such activity generally is expected to be limited to hedging of specific future commitments and long-term debt denominated in foreign currencies. CTHK had no foreign currency hedging activity in 1998.

The following table provides information regarding CTHK's interest rate sensitive financial instruments, which consist of fixed and variable rate short-term and long-term debt obligations, as of December 31, 1998 and 1997.

	As of December 31, 1998						As of December 31, 1997			
	Expected Maturity Date						Total Recorded Amount	Fair Value	Total Recorded Amount	Fair Value
	1999	2000	2001	2002	2003	Thereafter				
(RMB equivalent in millions, except interest rates)										
Debt:										
Fixed rate bank and other loans . . . . .	5,218	166	166	165	165	83	5,963	5,786	4,784	4,558
Average interest rate . . . . .	7.00%	7.50%	7.50%	7.50%	7.50%	7.50%	7.08%		7.92%	
Variable rate bank and other loans . . . . .	119	119	119	9	—	—	366	366	485	485
Average interest rate(1) . . . . .	6.06%	6.06%	6.06%	6.45%	—	—	6.07%		5.87%	

(1) The interest rates for variable rate bank and other loans is calculated based on the year end indice.

The following table provides information regarding CTHK's foreign currency sensitive financial instruments and transactions, which consist of cash and cash equivalents, short- and long-term debt obligations and capital commitments as of December 31, 1998 and 1997.

	As of December 31, 1998						As of December 31, 1997			
	Expected Maturity Date						Total Recorded Amount	Fair Value	Total Recorded Amount	Fair Value
	1999	2000	2001	2002	2003	Thereafter				
(RMB equivalent in millions, except interest rates)										
On-balance sheet financial instruments										
Cash and cash equivalents:										
in US dollars . . . . .	1,103	—	—	—	—	—	1,103	1,103	3,154	3,154
in Hong Kong dollars . . . . .	6,937	—	—	—	—	—	6,937	6,937	30,974	30,974
Debt:										
Fixed rate bank and other loans (US dollar) . . . . .	271	166	166	165	165	83	1,016	840	2,905	2,667
Average interest rate . . . . .	7.10%	7.50%	7.50%	7.50%	7.50%	7.50%	7.39%		7.46%	
Variable rate bank and other loans (US dollar) . . . . .	119	119	119	9	—	—	366	366	485	485
Average interest rate(1) . . . . .	6.06%	6.06%	6.06%	6.45%	—	—	6.07%		5.87%	
Off-balance sheet commitments:										
Capital commitments authorized and contracted for In US dollars . . . . .	3,088	—	—	—	—	—	3,088	3,088	6,770	6,770

(1) The interest rates for variable rate bank and other loans is calculated based on the year end indice.

## Item 10. Directors and Officers of Registrant.

The following table sets forth certain information concerning the directors and executive officers of CTHK Limited as of June 15, 1999.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Wang Xiaochu . . . . .	41	Chairman; President
Li Ping . . . . .	45	Vice Chairman; Executive Vice President
Ding Donghua . . . . .	62	Director; Chief Financial Officer
Lu Errui . . . . .	59	Director; Vice President
Zhu Jianhua . . . . .	45	Director; Vice President
He Ning . . . . .	37	Director; Vice President
Cui Xun . . . . .	60	Vice Chairman (Non-Executive Director)
Hu Wangshan . . . . .	55	Vice Chairman (Non-Executive Director)
Zhang Bingyin . . . . .	60	Vice Chairman (Non-Executive Director)
Arthur Li Kwok Cheung . . . . .	53	Non-Executive Director
Antony Leung Kam Chung . . . . .	47	Non-Executive Director

Mr. Wang Xiaochu is the Chairman and President of CTHK Limited. Mr. Wang is in charge of the overall management of the Company. He is also the Chairman and President of Telpo Communications (Group) Limited. Prior to joining CTHK, Mr. Wang served as the Director General of the Tianjin PTA. He also served as Director and Deputy Director of the Hangzhou PTB in Zhejiang province. He was responsible for the development of China Telecom system's telephone network management systems and various other information technology projects. Mr. Wang graduated from the Beijing University of Posts and Telecommunications in 1980 and has over 18 years of management experience in the telecommunications industry.

Mr. Li Ping is a Vice Chairman, Executive Vice President and Joint Company Secretary of CTHK Limited. Mr. Li is in charge of the business operations and investor relations of CTHK Limited. He previously served as Deputy Director General of the DGT and Deputy Director General of the Heilongjiang PTA. He graduated from the Beijing University of Posts and Telecommunications in 1976 and received an MBA degree from the State University of New York in 1989. Mr. Li has over 20 years' operational and management experience in the telecommunications industry.

Mr. Ding Donghua is a Director and Chief Financial Officer of CTHK Limited in charge of the overall financial management of CTHK. He was previously the Chief Economist, Chief Accountant, Deputy Chief Economist and Department Director of the Guangdong PTA. He graduated from the Beijing University of Posts and Telecommunications in 1961 and has 37 years' management experience in the telecommunications industry, as well as in economics and finance.

Mr. Lu Errui is a Director and Vice President of CTHK Limited in charge of the operations of Guangdong Mobile. Mr. Lu previously served as the Director and President of Guangdong Mobile and Director of Guangdong Mobile Communications Bureau. Mr. Lu graduated from the Chinese University of Science and Technology. He has over 20 years' experience in the telecommunications industry.

Mr. Zhu Jianhua is a Director and Vice President of CTHK Limited in charge of the operations of Zhejiang Mobile. Mr. Zhu is also the Director and President of Zhejiang Mobile. Mr. Zhu previously served as Deputy Director and Chief Engineer of the Hangzhou PTB in Zhejiang province. He graduated from the Nanjing Institute



of Posts and Telecommunications in 1985 and received a master's degree in computer science from Zhejiang University in 1992. Mr. Zhu has many years of experience in the telecommunications industry.

Mr. He Ning is a Director and Vice President of CTHK Limited in charge of the operations of Jiangsu Mobile. Mr. He is also a Director and President of Jiangsu Mobile. Mr. He previously served as the Director and Deputy Director of the Jiangsu Mobile Communications Bureau, and Deputy Director of the Zhenjiang PTB in Jiangsu province. He graduated from the Nanjing Institute of Posts and Telecommunications in 1983, and has 15 years of experience in the telecommunications industry.

Mr. Cui Xun is a Vice Chairman of CTHK Limited. Mr. Cui is also the Director General of the Guangdong PTA and the Chairman of Guangdong Mobile. He has served as Deputy Director General and Chief Engineer of the Guangdong PTA as well as Chief Engineer, Deputy Director and Deputy Chief Engineer of the Guangzhou PTB in Guangdong province. Mr. Cui graduated from the Beijing University of Posts and Telecommunications in 1962. He has 36 years' experience in the telecommunications industry.

Mr. Hu Wangshan is a Vice Chairman of CTHK Limited. Mr. Hu is also the Director General of the Zhejiang PTA and the Chairman of Zhejiang Mobile. He previously served as Deputy Director General of Zhejiang PTA as well as Director and Deputy Director of Shaoxing PTB in Zhejiang province. Mr. Hu graduated from the Beijing University of Posts and Telecommunications in 1968. He has over 30 years' experience in the telecommunications industry.

Mr. Zhang Bingyin is a Vice Chairman of CTHK Limited. Mr. Zhang is also the Director General of the Jiangsu PTA and the Chairman of Jiangsu Mobile. Previously, Mr. Zhang was the Deputy Director General of the Jiangsu PTA and Director and Deputy Director of the Changzhou PTB in Jiangsu. He graduated from the Posts and Telecommunications Institute for Managerial Personnel in 1987. Mr. Zhang has more than 40 years of experience in the telecommunications industry.

Professor Arthur Li Kwok Cheung is a Director of CTHK Limited. Professor Li is the Vice-Chancellor of the Chinese University of Hong Kong and a Non-Executive Director of Glaxo Wellcome plc, a Director of the Bank of East Asia Limited and a Non-Executive Director and Chairman of the Board of Regal Hotel Group plc. He holds a doctorate degree in medicine from Cambridge University and an honorary doctorate degree in science. He previously served as a board member of the Hong Kong Hospital Authority and President of the College of Surgeons of Hong Kong. Professor Li is an Advisor on Hong Kong Affairs to the People's Republic of China and a Member of the Basic Law Consultative Committee and was a Member of the Preparatory Committee of the Special Administrative Region of the National People's Congress, a Member of the Selection Committee of the First Government of the Hong Kong Special Administrative Region and a Committee Member of the Ninth Annual Chinese People's Political Consultative Conference.

Mr. Antony Leung Kam Chung is a Director of CTHK Limited. Mr. Leung is a Managing Director and Regional Manager for Greater China and the Philippines of The Chase Manhattan Bank. He graduated from the University of Hong Kong and completed the Program for Management Development at the Harvard Business School. Mr. Leung's public service appointments include Member of the Executive Council of the Hong Kong Special Administrative Region, Chairman of the Education Commission, Member of the Exchange Fund Advisory Committee, and Board Member of the Airport Authority.

There is no family relationship between any director or executive officer and any other director or executive officer of CTHK Limited.

**Item 11. Compensation of Directors and Officers.**

The aggregate amount of compensation paid by CTHK to directors and executive officers during 1998 for services performed as directors, officers or employees of CTHK was HK\$11,281,445 (US\$ 1,362,707).

**Item 12. Options to Purchase Securities from Registrant or Subsidiaries.**

CTHK Limited has adopted a share option scheme pursuant to which the directors of CTHK Limited may, at their discretion, invite employees, including executive directors, of CTHK Limited or any of its subsidiaries, to take up options to subscribe for ordinary shares up to a maximum aggregate number of ordinary shares equal to 10% of the total issued share capital of CTHK Limited. The consideration payable by a participant for the grant of an option under the share option scheme will be HK\$1.00. The price for an ordinary share payable by a participant upon the exercise of an option will be determined by the directors of CTHK Limited in their discretion, except that such price may not be set below a minimum price which is the higher of (i) the nominal value of an ordinary share and (ii) 80% of the average of the closing prices of ordinary shares on the Hong Kong Stock Exchange on the five trading days immediately preceding the date of grant of the option. The period during which an option may be exercised will be determined by the directors in their discretion, except that no option may be exercised later than 10 years after the adoption date of the scheme.

On April 20, 1999, Shi Cuiming, the former Chairman and Chief Executive Officer of CTHK Limited, exercised options to purchase an aggregate of 2,900,000 ordinary shares, and Chen Zhaobin, the former Vice Chairman and President of CTHK Limited, exercised options to purchase an aggregate of 2,600,000 ordinary shares, each at the exercise price of HK\$11.10 per share.

As of June 15, 1999, options exercisable for an aggregate of 6,500,000 ordinary shares had been granted to the following directors of CTHK Limited under the share option scheme and were outstanding:

<b>Director</b>	<b>Number of shares covered by options</b>
Li Ping .....	2,400,000
Ding Donghua .....	2,100,000
Lu Errui .....	1,000,000
Zhu Jianhua .....	1,000,000

Such options are exercisable at a price of HK\$11.10 per ordinary share during the period from March 9, 1998 through March 8, 2006.

**Item 13. Interest of Management in Certain Transactions.**

As of December 31, 1998, the MII indirectly owned an aggregate of 76.5% of CTHK Limited's issued share capital. The MII and the DGT have jointly undertaken that they will extend their support to CTHK's present operations and future development. CTHK's operations, along with those of other cellular telephone system operators in mainland China, are subject to a high degree of regulation by the MII. The MII has undertaken that, to the extent within its power, CTHK will be treated equally with any other cellular operators in respect of all approvals, transactions and arrangements between CTHK, on the one hand, and entities within the China Telecom system, on the other hand. The MII has also undertaken that CTHK Limited will be the only cellular telecommunications services company in the China Telecom system operating in mainland China under its control

that will be listed on any securities exchange in Hong Kong or outside China. In addition, the MII has undertaken that the China Telecom system will not participate, directly or indirectly, in the provision of cellular telecommunications services in any province in which CTHK currently operates or may operate in the future. In connection therewith, the MII has undertaken to contribute to CTHK, at CTHK's option, the entire interest, if any, held by the China Telecom system in the CDMA Project in any such province when and if the CDMA Project, after trial operations, becomes commercially feasible.

In connection with the IPO Restructuring, CTHK entered into various agreements with the DGT and certain other entities within the China Telecom system. These transactions are described below. In connection with the acquisition of Jiangsu Mobile, CTHK Limited and Jiangsu Mobile have entered into similar transactions with the Jiangsu PTA and the DGT. CTHK cannot predict what effects, if any, the restructuring of the telecommunications industry in mainland China may have on such arrangements.

#### ***Leasing of Offices and Sites for Network Equipment***

The Guangdong, Zhejiang and Jiangsu PTAs have leased certain premises to CTHK for use as offices, warehouses and sites for locating equipment for terms of between three to fifty years. The rental payments under these lease agreements are determined with reference to market rates.

The Hong Kong current head office of CTHK Limited is sub-leased from Telpo Communications (Group) Limited pursuant to a tenancy agreement which will expire on June 30, 2000. The yearly rental for the office is approximately HK\$2.6 million.

#### ***Leasing of Transmission Lines***

CTHK leases certain transmission lines from the Guangdong, Zhejiang and Jiangsu PTAs in order to link CTHK's base transceiver stations, base station controllers and mobile switching centers and to interconnect CTHK's network to the China Telecom system's PSTN. Leased line agreements were entered into in September 1997 between Guangdong Mobile and the Guangdong PTA and between Zhejiang Mobile and the Zhejiang PTA, respectively. The agreements are for an initial term of ten years and two months in Guangdong and five years and two months in Zhejiang, in each case from October 20, 1997, and will be automatically renewed for another ten years and five years, respectively, unless either party notifies the other of its intention to terminate at least six months prior to the expiration of the term. A similar agreement was entered into in April 1998 between Jiangsu Mobile and the Jiangsu PTA for an initial term of ten years from January 1, 1998. The agreement will be automatically renewed for an additional year unless Jiangsu Mobile notifies Jiangsu PTA of its intention to terminate at least three months prior to the expiration of the renewed term and, after the renewed term, is terminable at any time by either party upon three months' prior notice. Lease payments are standardized and are based on tariff schedules stipulated by the MII and the SDPC from time to time which are applicable to other cellular and fixed line operators.

Prior to the IPO Restructuring, CTHK paid to the Guangdong PTA a portion of Guangdong Mobile's operating revenues as a monthly fee for the leasing of local transmission lines and a fixed monthly fee per line for the leasing of long distance transmission lines. In Zhejiang, CTHK paid to the Zhejiang PTA a fixed fee for the leasing of both local and long distance transmission lines. Prior to the acquisition by CTHK, Jiangsu Mobile paid the Jiangsu PTA a fixed fee for the leasing of both local and long distance transmission lines.

#### ***Interconnection Arrangements***

CTHK's networks interconnect with the China Telecom system's PSTN, allowing CTHK's subscribers to communicate with fixed line users and subscribers of other cellular networks and to make and receive domestic and international long distance calls. Interconnection agreements were entered into between Guangdong Mobile and the Guangdong PTA in October 1997, between Zhejiang Mobile and the Zhejiang PTA in September 1997, and between Jiangsu Mobile and the Jiangsu PTA in April 1998. The Guangdong and Zhejiang agreements are for an initial term of one year from October 20, 1997 and are renewable at the option of Guangdong Mobile and Zhejiang Mobile, as

the case may be, subject, in the case of Guangdong Mobile, to the right of the parties to reconsider certain terms of the agreement. Guangdong Mobile and Zhejiang Mobile have elected to renew the agreements through October 20, 1999. The Jiangsu interconnection agreement is for an initial term of three years from January 1, 1998 and will be automatically renewed on an annual basis unless either party notifies the other of its intention to terminate at least three month prior to the expiration of the term.

The interconnection agreements set forth the amounts payable by the relevant PTA to CTHK for inbound calls to CTHK's subscribers which originate from the PSTN and the amounts payable by CTHK to the relevant PTA for outbound calls from CTHK's subscribers which terminate on the PSTN. See "Item 1. Description of Business — Operations — Interconnection Revenue and Costs". The agreements provide that CTHK will be entitled to benefit from more favorable interconnection arrangements, if any, entered into between the Guangdong PTA, the Zhejiang PTA or the Jiangsu PTA (as the case may be) and any other cellular operator in the future. The fees payable by CTHK under the interconnection arrangements are standard and applied uniformly to cellular operators in mainland China, including Unicom.

### ***Billing Services***

Certain billing services relating to CTHK's cellular operations in Zhejiang are provided by the Zhejiang PTA and the relevant PTBs pursuant to an agreement between Zhejiang Mobile and the Zhejiang PTA, entered into in September 1997. The agreement, as renewed, will be valid through October 20, 1999. Pursuant to the agreement, the billing services are provided to Zhejiang Mobile at the rate of RMB 0.20 per bill. In the event that Zhejiang Mobile's own billing system is established, Zhejiang Mobile may terminate the agreement with one month's prior written notice to the Zhejiang PTA.

### ***Collection Services***

Certain payment collection services relating to CTHK's cellular operations in Guangdong are provided by the Guangdong PTA and the relevant PTBs pursuant to an agreement between Guangdong Mobile and the Guangdong PTA, entered into in September 1997. The agreement is for an initial term of three years from October 20, 1997. The agreement is terminable at any time after two years from the date thereof upon six months' prior written notice and, unless either party notifies the other in writing at least three months prior to the end of the initial term of their intention to terminate, the agreement will be automatically extended for another three years. Jiangsu Mobile and the Jiangsu PTA have also entered into an agreement with respect to payment collection services. The agreement is for a period of one year from January 1, 1998 and will be automatically renewed on an annual basis unless terminated by Jiangsu Mobile upon three months' notice prior to the expiration date.

Pursuant to the collection services agreements, the collection services are provided to Guangdong Mobile and Jiangsu Mobile at the rate of RMB 0.01 per RMB 1.00 collected. Guangdong Mobile and Jiangsu Mobile also rely on authorized distributors not affiliated with the China Telecom system for certain collection services.

### ***Distribution and Marketing Arrangements***

CTHK markets and sells its cellular services in Zhejiang and Jiangsu and GSM services in Guangdong, in part, through a total of approximately 1248 authorized dealers within the China Telecom system, and post offices and other outlets, pursuant to marketing agreements between Guangdong Mobile and the Guangdong PTA and between Zhejiang Mobile and the Zhejiang PTA, each entered into in September 1997. The agreements in Zhejiang and Guangdong, as renewed, will be valid through October 20, 1999. The agreement in Jiangsu is for an initial term of five years from January 1, 1998 and will be automatically renewed for another year unless Jiangsu Mobile notifies Jiangsu PTA its intention to terminate at least three months prior to the expiration of the term.

In connection with such services, CTHK pays such dealers a fee of not more than RMB 300 per new subscriber acquired. In addition, the authorized dealers pay to CTHK CTHK's standard charges to new subscribers

such as connection fees and telephone number selection fees. The payment arrangements under the agreements are similar to those between CTHK and its other authorized dealers not affiliated with the China Telecom system.

### ***Roaming Arrangements***

CTHK offers automatic roaming services to its subscribers, which permits subscribers to make and receive telephone calls while they are outside of their registered service area, including in the coverage area of other cellular systems with which the user's home system has a roaming arrangement. The MII has promulgated regulations governing the sharing of roaming usage revenue among cellular operators within the China Telecom system. CTHK Limited entered into an agreement with the DGT in September 1997 with respect to domestic and international roaming services offered to subscribers of Guangdong Mobile and Zhejiang Mobile. The agreement provides for the sharing of roaming revenue between CTHK and other cellular operators and procedures and timing of payment settlement. See "Item 1. Description of Business — Operations — Roaming Services". The agreement, as renewed, will be valid through October 20, 1999. In April 1998, the agreement was supplemented to provide the same arrangement for Jiangsu Mobile for an initial term of one year from January 1998, which will be automatically extended for another year unless either party notifies the other of its intention to terminate.

### ***Licensing of Trademark***

The DGT is the owner of the "China Telecom" logo. Pursuant to a non-exclusive license agreement entered into between the DGT and CTHK Limited in September 1997, CTHK has obtained the right to use such trademark for a term of six years from October 20, 1997. No license fee is payable by CTHK in respect of the first three years and the fees payable thereafter, if any, shall be no less favorable than fees paid by other entities within the China Telecom system for the use of such DGT trademark logo. The DGT may license the trademark to other affiliated parties but may not unilaterally terminate the license agreement.

### ***Spectrum Fees***

The MII and the Ministry of Finance (the "MOF") jointly determine the standardized spectrum fees payable to the MII by all cellular operators in mainland China, including CTHK. Based on such standardized fee scale, the DGT determines the allocation of spectrum usage fees to be paid by each cellular operator under the MII's control and the aggregate sum paid to the MII. The spectrum fees collected by the DGT in respect of CTHK are paid to the MII, and are eventually paid by the MII to the MOF. CTHK paid spectrum fees of approximately RMB 12.4 million for the year ended December 31, 1998.

### ***Loan Arrangements***

Guangdong Mobile entered into a loan agreement in July 1997 with Telpo, a company controlled by the MII, under which Telpo agreed to advance to Guangdong Mobile US\$166.96 million for the purpose of acquiring cellular telecommunications facilities. The loan was repayable in three years in semi-annual installments at an interest rate of 7.5% per annum. The loan was fully repaid in January 1998.

### ***Miscellaneous***

The transactions mentioned above have been entered into in the ordinary course of business and on normal commercial terms. Under the Listing Rules of the Hong Kong Stock Exchange (the "Listing Rules"), such transactions are considered to be "connected transactions" and would normally require full disclosure and prior independent shareholders' approval on each occasion they arise. As the transactions are expected to be continued in the normal course of business, the Directors consider that such disclosure and approval would be impractical. Accordingly, the Directors have requested the Hong Kong Stock Exchange to grant a waiver from these requirements. On the basis of confirmations received that the transactions have been entered into in the usual and ordinary course of business, on normal commercial terms and are fair and reasonable, the Hong Kong Stock

Exchange has indicated that a waiver would be granted from compliance with the normal approval and disclosure requirements related to connected transactions under the Listing Rules on the following conditions:

(a) details of the transactions as set out in rule 14.25(1)(A) to (D) of the Listing Rules, shall be disclosed in CTHK Limited's annual report;

(b) CTHK Limited's independent non-executive Directors shall review annually the transactions and confirm in CTHK Limited's next annual report that:

- (i) the transactions have been entered into by CTHK Limited in the ordinary and usual course of its business;
- (ii) the transactions have been entered into on terms that are fair and reasonable so far as the shareholders of CTHK Limited are concerned;
- (iii) the transactions have been entered into on normal commercial terms and either (1) in accordance with the terms of the agreement governing such transactions or (2) (where there is no such agreement) on terms no less favorable than terms available to third parties; and

the auditors of CTHK Limited shall review annually the transactions, details of which shall be set forth in CTHK Limited's annual report and accounts and confirm in CTHK Limited's next annual report as well as provide the Directors of CTHK Limited with a letter stating that;

- (i) the transactions have received the approval of the Directors; and
- (ii) the transactions have been conducted in the manner as stated in paragraph (b)(iii) above.

The MII, on its own behalf and on behalf of relevant entities within the China Telecom system and CTHK Limited, have confirmed to the Hong Kong Stock Exchange that the auditors will be granted access to such records of CTHK Limited as the auditors consider necessary for the purpose of reviewing the transactions mentioned above.

The Hong Kong Stock Exchange has indicated that if any of the terms of the agreements referred to above are altered (other than as provided for in the relevant agreements) or if CTHK enters into any new arrangements with connected persons in the future, CTHK Limited must comply with the relevant requirements of the Listing Rules. In respect of the interconnection arrangements described above, the Hong Kong Stock Exchange has indicated that upon the expiry of the existing agreements, or their amendment to reflect more favorable interconnection arrangements entered into between the Guangdong PTA, the Zhejiang PTA or Jiangsu PTA and other cellular operators in the future, the waiver requested of the Hong Kong Stock Exchange will also apply to the terms agreed upon such expiry or amendment, provided that in the opinion of an independent financial adviser the new terms are no less favorable to CTHK than the previous interconnection arrangements and provided further that CTHK Limited issues a press announcement describing the new arrangements. Any other change to the existing arrangements will require full compliance with the relevant requirements of the Listing Rules.

## PART II

### Item 14. Description of Securities to be Registered.

Not Applicable.

## PART III

### Item 15. Defaults Upon Senior Securities.

None.

### Item 16. Changes in Securities, Changes in Security for Registered Securities and Use of Proceeds.

#### Change in Securities and Changes in Security For Registered Securities

None.

#### Use of Proceeds

The following use of proceeds information relates to the registration statement on Form F-1 (File No. 333-7634) filed by CTHK Limited in connection with its IPO. The effective date of the registration statement was October 15, 1997.

The net offering proceeds to CTHK Limited from the sale of ordinary shares registered pursuant to the registration statement (the "Registered Shares") were US\$2,329,581,581. The combined net proceeds to CTHK Limited from (i) the sale of the Registered Shares and (ii) the concurrent sale of ordinary shares to certain corporate investors in reliance on Regulation S under the Securities Act, which shares were not registered under the Securities Act, were US\$4,039,738,989.

As of December 31, 1998, approximately RMB 24.1 billion (US\$2.9 billion) of such combined net proceeds had been used to fund the acquisition of Jiangsu Mobile from China Telecom Hong Kong (BVI) Limited, CTHK Limited's parent company, and approximately RMB 3.8 billion (US\$453.2 million) had been used to fund the expansion of CTHK's cellular networks in Guangdong, Zhejiang and Jiangsu. The remainder of the proceeds were held in bank deposits as of December 31, 1998. None of the network-related payments were direct or indirect payments to directors, officers or affiliates of CTHK.

## PART IV

### Item 17. Financial Statements.

CTHK Limited has elected to provide the financial statements and related information specified in Item 18 in lieu of Item 17.

## Item 18. Financial Statements.

The following financial statements are filed as part of this annual report.

### China Telecom (Hong Kong) Limited:

Index to consolidated financial statements .....	F-1
Independent auditors' report .....	F-2
Consolidated statements of income for each of the years ended December 31, 1998, December 31, 1997 and December 31, 1996 .....	F-3
Consolidated balance sheets as of December 31, 1998 and 1997 .....	F-5
Consolidated statements of cash flows for each of the years ended December 31, 1998, December 31, 1997 and December 31, 1996 .....	F-7
Consolidated statements of shareholders' equity for each of the years ended December 31, 1998, December 31, 1997 and December 31, 1996 .....	F-12
Notes to consolidated financial statements .....	F-13

## Item 19. Financial Statements and Exhibits.

- (a) See Item 18 for a list of the financial statements filed as part of this annual report.
- (b) Exhibits to this annual report:
- 2.1 Conditional Acquisition Agreement, dated April 28, 1998, between China Telecom (Hong Kong) Limited and China Telecom Hong Kong (BVI) Limited.
  - 10.1 Agreement Regarding Network Interconnection and Settlement of Accounts, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).
  - 10.2 Transmission Line Leasing Agreement, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).
  - 10.3 Collection Agreement, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).
  - 10.4 Distribution and Marketing Agreement, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).



- 10.5 Supplemental Agreement, dated April 27, 1998, to Domestic and International Roaming Agreement between China Telecom (Hong Kong) Limited and China Directorate General of Telecommunications (together with English translation).
- 10.6 Master Building Contract, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).
- 10.7 Asset Partition Agreement, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).
- 10.8 Supplemental Agreement, dated November 26, 1998, to the Billing Agreement, Distribution and Marketing Agreement, and the Agreement Regarding Network Interconnection and Settlement of Accounts, each between Zhejiang Mobile Communication Company Limited and Zhejiang Posts and Telecommunications Administration (together with English translation).
- 10.9 Agreement Regarding Network Interconnection and Settlement of Accounts, dated October 15, 1998, between Guangdong Mobile Communication Company Limited and Guangdong Posts and Telecommunications Administration (together with English translation).
- 10.10 Marketing Agreement, dated October 15, 1998, between Guangdong Mobile Communication Company Limited and Guangdong Posts and Telecommunications Administration (together with English translation).

## SIGNATURES

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all of the requirements for filing on Form 20-F and has duly caused this annual report to be signed on its behalf by the undersigned, thereunto duly authorized.

CHINA TELECOM (HONG KONG) LIMITED

By: /s/ Wang Xiaochu  
Name: Wang Xiaochu  
Title: Chairman and President

Date: June 22, 1999

## Exhibit Index

<u>Exhibit Number</u>	<u>Description of Exhibit</u>	<u>Page Number</u>
2.1	Conditional Acquisition Agreement, dated April 28, 1998, between China Telecom (Hong Kong) Limited and China Telecom Hong Kong (BVI) Limited.	122
10.1	Agreement Regarding Network Interconnection and Settlement of Accounts, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).	169
10.2	Transmission Line Leasing Agreement, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).	190
10.3	Collection Agreement, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).	204
10.4	Distribution and Marketing Agreement, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).	217
10.5	Supplemental Agreement, dated April 27, 1998, to Domestic and International Roaming Agreement between China Telecom (Hong Kong) Limited and China Directorate General of Telecommunications (together with English translation).	235
10.6	Master Building Contract, dated April 27, 1998, between Jiangsu Mobile Communication Company Limited and Jiangsu Posts and Telecommunications Administration (together with English translation).	242
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10.9	Agreement Regarding Network Interconnection and Settlement of Accounts, dated October 15, 1998, between Guangdong Mobile Communication Company Limited and Guangdong Posts and Telecommunications Administration (together with English translation).	294
10.10	Marketing Agreement, dated October 15, 1998, between Guangdong Mobile Communication Company Limited and Guangdong Posts and Telecommunications Administration (together with English translation).	313