

# Management Discussion & Analysis of Financial Conditions and Results of Operations

## Overview

On 31 August 2007, the Company completed the acquisition from China Telecommunications Corporation of the businesses (the “Target Business”) which comprise the leading providers of specialized telecommunications support services in 13 provinces (municipality and autonomous regions), including Jiangsu Province, Anhui Province, Jiangxi Province, Hunan Province, Guangxi Zhuang Autonomous Region, Chongqing Municipality, Sichuan Province, Guizhou Province, Yunnan Province, Shaanxi Province, Gansu Province, Qinghai Province and Xinjiang Uygur Autonomous Region, together with the equity interests in Guangdong Nanfang Communication GSM Intelligent Card System Co., Ltd. and Ningbo Public Information Industry Co., Ltd.. As the Target Business was under common control of China Telecommunications Corporation, the acquisition of the Target Business has been reflected in the accompanying consolidated financial statements as a combination of entities under common control and accounted for in a manner similar to pooling-of-interests. Accordingly, the assets and liabilities of the Target Business have been accounted for at historical costs and the consolidated financial statements of the Company prior to the foregoing acquisition have been restated to include the financial conditions and results of operations of the Target Business on a combined basis. Unless otherwise stated in this section, the financial information for the periods prior to the acquisitions was restated.

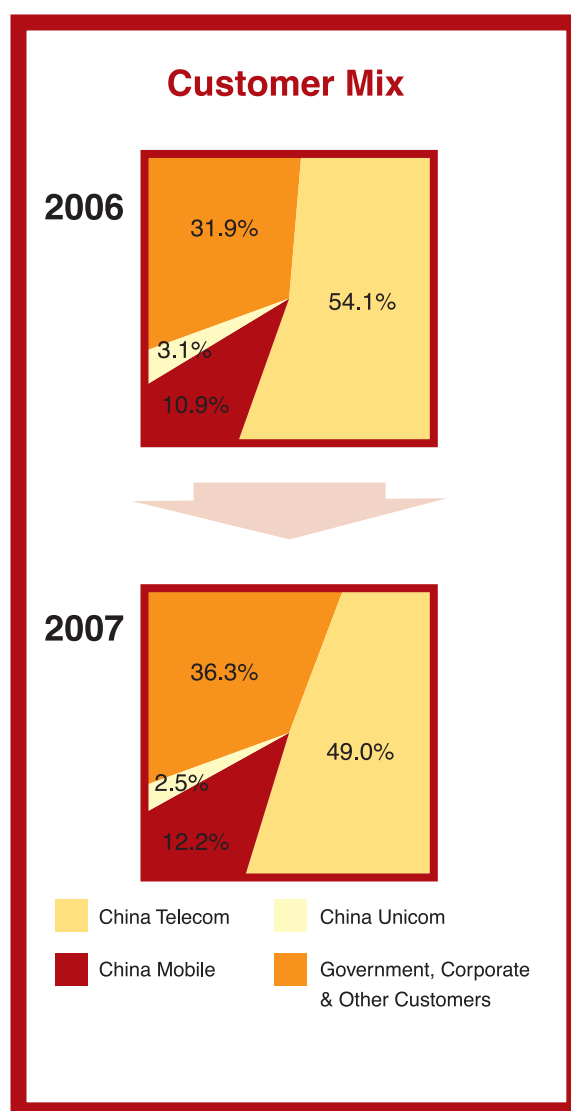
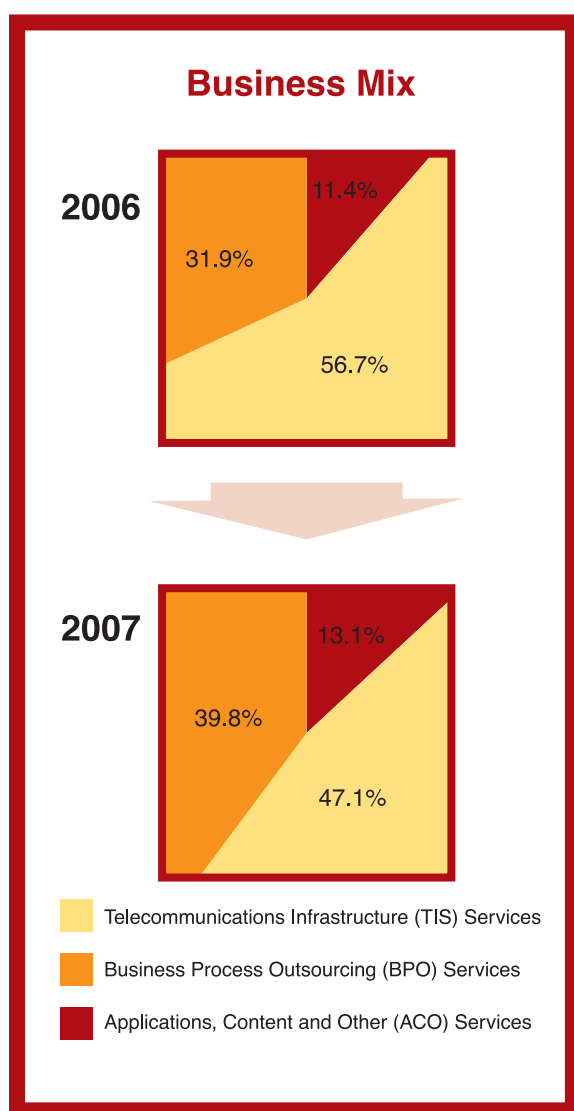
In 2007, the Company continued to adhere to its established development strategies. By pursuing the complementary development strategies of organic and external growth, along with other measures such as the effective sales and marketing strategies and comprehensive budget management, the Company achieved favourable operating results. Our revenues amounted to RMB23,538.38 million, an increase of 21.9% from 2006. Profit attributable to equity shareholders/owner of the Company was RMB1,167.25 million, an increase of 42.9% from 2006. Basic earnings per share were RMB0.214, an increase of 6.5% from 2006. The free cash flow turned positive.

In 2007, the Company successfully completed its acquisitions of the Target Business from its parent company. With the Company’s effective integration measures and enhancement in management efficiency, the Target Business achieved satisfactory results and their profits met our expectations, resulting in accretion to our earnings per share. Our leading market position and competitiveness were further strengthened, thereby providing a promising prospect for our further development.

## Revenues

Our revenues in 2007 were RMB23,538.38 million, an increase of 21.9% from 2006. Of which, revenue from telecommunications infrastructure services was RMB11,093.01 million, an increase of 1.4% from 2006; revenue from business process outsourcing services was RMB9,365.15 million, an increase of 51.8% from 2006; revenue from applications, content and others was RMB3,080.22 million, an increase of 39.7% from 2006. Business process outsourcing services and applications, content and others

were the major sources of our revenues growth in 2007. In terms of customers structure, the Company's revenues from customers other than China Telecommunications Corporation amounted to RMB12,004.84 million, representing 51.0% of the total revenues, an increase of 5.1 percentage points from 45.9% in 2006. Revenues from China Mobile Communications Corporation and government agencies and corporate customers increased significantly when compared with 2006. The Company's composition of revenues was further optimized.



# Management Discussion & Analysis of Financial Conditions and Results of Operations

The following table sets forth a breakdown of our revenues for 2006 and 2007, together with their respective rates of change:

	2007	2006	Percentage change
	<i>(RMB in thousands, except percentage data)</i>		
<b>Telecommunications Infrastructure Services</b>			
Design services	2,436,345	2,341,945	4.0%
Construction services	8,071,188	8,082,346	(0.1)%
Project supervision and management services	585,474	516,884	13.3%
	11,093,007	10,941,175	1.4%
<b>Business Process Outsourcing Services</b>			
Network maintenance	1,572,953	722,646	117.7%
Distribution of telecommunications services and products	6,097,148	4,017,846	51.8%
Facilities management	1,695,051	1,426,905	18.8%
	9,365,152	6,167,397	51.8%
<b>Applications, Content and Others</b>			
IT applications	1,546,478	1,009,513	53.2%
Internet service	478,022	343,769	39.1%
Voice VAS	325,661	286,990	13.5%
Other	730,061	563,888	29.5%
	3,080,222	2,204,160	39.7%
<b>Total</b>	<b>23,538,381</b>	<b>19,312,732</b>	<b>21.9%</b>

## **Telecommunications Infrastructure Services**

In 2007, our revenue from telecommunications infrastructure services was RMB11,093.01 million, which was still our primary source of income. This business accounted for 47.1%, representing a decrease of 9.6 percentage points from 56.7% in 2006, due to more rapid development of our business process outsourcing services and applications, content and others. Revenue from this business was mainly related to the capital expenditure of telecommunications operators. In anticipation of the ongoing control over capital expenditure by fixed line operators, we actively explored business opportunities with other telecommunications operators, thereby having successfully maintained the continued stable growth in this business. As a result, the revenue from this business increased by 1.4% in 2007 from RMB10,941.18 million in 2006.

## **Business Process Outsourcing Services**

In 2007, our revenue from business process outsourcing services was RMB9,365.15 million, representing an increase of 51.8% over RMB6,167.40 million for 2006. Business process outsourcing services accounted for 39.8% of our revenues, representing an increase of 7.9 percentage points from 31.9% of 2006. Of which, revenue from distribution of telecommunications services and products was RMB6,097.15 million, representing an increase of 51.8% from 2006.

The increase was mainly due to the continuous rapid growth in our sales of mobile handsets and telecommunications terminals, and the further development of our logistics distribution services in 2007. Besides, in 2007, the major telecommunications operators aggressively outsourced its network maintenance with a view to improve its service quality and lower their operating costs. This provided an excellent opportunity for the Company to develop its market in the network maintenance business. In 2007, revenue from the network maintenance business amounted to RMB1,572.95 million, an increase of 117.7% from 2006.

## **Applications, Content and Others**

In 2007, the Company made significant efforts in developing its business in applications, content and others, thereby leading to our business growth. In particular, there was greater business growth in IT applications, which included system integration, telecommunications network support services and software development. As a result of our efforts, this business achieved a rapid revenue growth, amounting to RMB3,080.22 million, representing 13.1% of the total revenues and an increase of 39.7% over RMB2,204.16 million in 2006. Of which, revenue from the IT applications amounted to RMB1,546.48 million, an increase of 53.2% from 2006. The Company expects this business will become the major contributor to our future revenue growth.

# Management Discussion & Analysis of Financial Conditions and Results of Operations

## Cost of Revenues

Our cost of revenues in 2007 was RMB19,473.63 million, representing an increase of 23.7% from 2006 and accounting for 82.7% of the revenues.

The following table sets out a breakdown of our cost of revenues in 2006 and 2007 and their respective rates of change:

	2007	2006	Percentage change
	<i>(RMB in thousands, except percentage data)</i>		
Direct personnel costs	4,556,857	3,937,327	15.7%
Depreciation and amortization	305,205	326,673	(6.6)%
Purchase of materials and telecommunications products	7,632,433	5,712,317	33.6%
Subcontracting charges	4,577,237	3,582,311	27.8%
Operating lease charges and others	2,401,900	2,187,169	9.8%
Total cost of revenues	19,473,632	15,745,797	23.7%

## Direct Personnel Costs

In 2007, direct personnel costs were RMB4,556.86 million, which accounted for 19.4% of revenues and an increase of 15.7% over RMB3,937.33 million for 2006. On one hand, the Company effectively controlled the personnel costs through strict control over the total headcounts, ensuring that personnel costs grew at a rate slower than the growth of revenues, while on the other hand, we provided initiatives to different levels of personnel through the establishment of a performance appraisal system, improvement in our remuneration system and staff allocation structure.

## Depreciation and Amortization

In 2007, depreciation and amortization amounted to RMB305.21 million, which accounted for 1.3% of the revenues and a decrease of 6.6% over RMB326.67 million for 2006.

## Purchase of Materials and Telecommunications Products

In 2007, our business of distribution of telecommunications services and products continued to grow strongly, resulting in a significant increase in revenues. Accordingly, the cost of the purchase of materials and telecommunications products increased significantly, amounting to RMB7,632.43 million, representing 32.4% of revenues and an increase of 33.6% from RMB5,712.32 million for 2006. Of which, the cost of the purchase of construction materials was RMB2,688.26 million, a decrease from RMB3,000.25 million for 2006, and the cost of the purchase of telecommunications products was RMB4,944.18 million, an increase of 82.3% over RMB2,712.07 million for 2006.

## **Subcontracting Charges**

In 2007, subcontracting charges were RMB4,577.24 million, which accounted for 19.4% of revenues and represented an increase of 27.8% over RMB3,582.31 million for 2006. The increase in subcontracting charges was mainly derived from the construction business and network maintenance business. Subcontracting charges of the construction business increased mainly because the Company continued to improve its business subcontracting arrangement. The new subcontracting arrangement required subcontractors to bear the costs of materials. This arrangement resulted in saving of the Company's working capital and minimized its exposure to material price fluctuations. In 2007, as the network maintenance business grew significantly, the Company increased its outsourcing of low-end maintenance business.

## **Operating Lease Charges and Others**

In 2007, operating lease charges and others were RMB2,401.90 million, which accounted for 10.2% of the revenues and represented an increase of 9.8% over RMB2,187.17 million for 2006.

## **Gross Profit**

In 2007, the Company's gross profit amounted to RMB4,064.75 million, representing an increase of RMB497.81 million from RMB3,566.94 million in 2006. The Company's gross profit margin in 2007 was 17.3%, representing a decrease of 1.2 percentage points over 18.5% in 2006. In 2007, the performance of the business of distribution of telecommunications services and products was strong with a significant increase in revenues. However, its gross profit margin was lower than the overall gross profit margin, resulting in a decrease in our gross profit margin. In addition, the Company adopted a more competitive pricing strategy that expanded the business while to certain extent affected the gross profit margin.

## **Selling, General and Administrative Expenses**

Our selling, general and administrative expenses in 2007 were RMB2,794.66 million, representing an increase of 12.8% over RMB2,476.88 million for 2006. Through strengthening of comprehensive budget management, the Company effectively controlled its selling, general and administrative expenses. In 2007, the selling, general and administrative expenses accounted for 11.9% of the revenues, representing a decrease of 0.9 percentage points over 12.8% in 2006.

# Management Discussion & Analysis of Financial Conditions and Results of Operations

## Net Financing Income

In 2007, our net financing income was RMB41.68 million, a decrease of RMB45.64 million, or 52.3%, over RMB87.32 million for 2006. The net financing income in 2006 included the interest income accrued on the application money during our initial public offering in 2006 (the “IPO”).

## Income Tax

Except for subsidiaries incorporated in high-technology zone, special economic region or certain subsidiaries operating in western part of China which are subject to a preferential income tax rate of 15%, the Company and other subsidiaries of the Group are subject to an income tax rate of 33%. The income tax in 2007 was RMB461.06 million and our effective tax rate was 28.0%. The difference between our effective tax rate and the statutory tax rate was mainly due to the effect of the aforesaid preferential tax rate of the subsidiaries.

## Profit Attributable to Equity Shareholders/Owner

In 2007, profit attributable to equity shareholders/owner of the Company was RMB1,167.25 million, an increase of 42.9% over RMB816.75 million for 2006. Excluding the deficit of RMB135.63 million on revaluation of property, plant and equipment arising pursuant to the restructuring in 2006, profit attributable to equity shareholder of the Company was up by 22.6%.

## Capital Expenditure

Our Company implemented strict budget management, and adjusted the capital expenditure plan according to changes in market condition. In 2007, our capital expenditure, excluding those for the acquisition of the Target Business in 2007, amounted to RMB719.54 million, a decrease of 25.9% over RMB971.60 million in 2006, excluding the acquisition of assets relating to our restructuring in 2006. The capital expenditure in 2007 represented 3.1% of our total revenues, a decrease of 1.9 percentage point compared with 2006. Our capital expenditure included the purchase of production equipments, facilities, machineries, vehicles, office equipments, plant and buildings and other operating assets.



## Cash Flows and Capital Resources

### Cash Flows

In 2007, our net cash outflow was RMB1,530.37 million. In 2006, our net cash inflow was RMB3,207.89 million. By the end of 2007, the

amount of our cash and cash equivalents was RMB6,632.25 million, of which 99.7% was accounted for in Renminbi.

The following table sets out our cash flow position in 2006 and 2007, respectively:

	2007 (RMB in thousands)	2006
Net cash generated from operating activities	1,663,776	424,454
Net cash used in investing activities	(5,183,186)	(801,637)
Net cash generated from financing activities	1,989,038	3,585,070
Net (decrease)/increase in cash and cash equivalents	(1,530,372)	3,207,887

In 2007, our net cash generated from operating activities was RMB1,663.78 million, an increase of RMB1,239.33 million from RMB424.45 million for 2006. The significant increase in net cash inflow from operating activities was mainly due to the rapid development of our operations and the improvement of our working capital management.

In 2007, our net cash used in investing activities was RMB5,183.19 million, an increase of RMB4,381.55 million over RMB801.64 million for 2006, which was mainly due to the successful acquisition of the Target Business from our parent company for a consideration of RMB4.6 billion.

In 2007, our net cash generated from financing activities was RMB1,989.04 million. In 2006, net cash generated from financing activities was RMB3,585.07 million. Our cash generated from financing activities during the year included the debt financing of RMB1.6 billion in respect of the consideration of the acquisition of the Target Business from our parent company. In 2006, our net cash generated from financing activities was mainly due to the proceeds from our IPO.

### Working Capital

By the end of 2007, our working capital (i.e. non-cash current assets minus operating current liabilities) was RMB414.10 million, an increase of RMB26.66 million from RMB387.44 million in 2006. While achieving rapidly increase of operating revenues, we strengthened our management of prepayments and obtained more favourable credit terms, and thereby maintained working capital at a stable level.



# Management Discussion & Analysis of Financial Conditions and Results of Operations

## Indebtedness

By the end of 2007, our total indebtedness was RMB2,561.22 million, the majority of which was fixed interest rate loans, representing an increase of RMB2,390.52 million from RMB170.70 million in 2006. As stated in the circular regarding the acquisitions of the Target Business dated 20 June 2007, we intended to borrow RMB2.0 billion to finance the acquisitions. In its actual operations, through effective cash management, the Company fully utilized its internal funding and only RMB1.6

billion debt financing was materialized. Apart from this, all other new loans were short-term loans borrowed by the subsidiaries as supplement to working capital.

By the end of 2007, our gearing ratio<sup>(1)</sup> was at a more reasonable level of 21.1%, an increase of 19.7 percentage point from 1.4% in 2006.

## Contractual Obligations

The following table sets out our contractual obligations as of 31 December 2007:

	Total	2008	2009	2010	2011	2012	After 2012
<i>(RMB in thousands)</i>							
Short-term debt	2,560,256	2,560,256	–	–	–	–	–
Long-term debt	960	–	960	–	–	–	–
Operating lease commitments	286,361	119,888	73,898	56,743	26,388	4,326	5,118
Capital commitments	47,368	47,368	–	–	–	–	–
Of which:							
Authorized and contracted	9,714	9,714	–	–	–	–	–
Authorized but not contracted	37,654	37,654	–	–	–	–	–
Total of contractual obligations	2,894,945	2,727,512	74,858	56,743	26,388	4,326	5,118

<sup>(1)</sup> Gearing ratio equals to total interest-bearing debts divided by the sum of total interest-bearing debts and total equity at the end of each financial year.

## Exchange Rate

Most of our Company's revenues and expenses are settled in Renminbi, therefore the risks associated with foreign currency exchange rate have no significant impact on our business performance. By the end of 2007, the balance of our cash and cash equivalents in foreign currencies only accounted for 0.3% of our total cash and cash equivalents.

## Acquisitions and Integration

Our Company completed the acquisition of the Target Business in August 2007. Upon the completion of the acquisition, we reinforced the integration of the Target Business and further enhanced the management efficiency and operational efficiency of these companies. In 2007, the results of the Target Business reached the profit forecast stated in the acquisition

circular sent to the shareholders dated 20 June 2007. The revenues of the Target Business amounted to RMB6,242.24 million in 2007, representing an increase of 21.7% over 2006. The profit attributable to the shareholders/owner was RMB284.38 million<sup>(2)</sup>, an increase of 135.7% from 2006. Meanwhile, the operational efficiency of the Target Business has been improved considerably. The account receivable turnover days were 156 days in 2007, 19 days less than that of 2006. The selling, general and administrative expenses accounted for 12.2% of the total revenues, a decrease of 4.6 percentage point over 2006. The favourable performance of the Target Business resulted in significant earnings per share accretion to our Company. In view of the further internal integration in future, we believe that we will create even greater values to the shareholders.

<sup>(2)</sup> Including the relevant financing cost of acquisition









## Applications, Content and Other (ACO) Services

We offer a variety of IT applications, Internet services, value added voice services, and other services for telecommunications operators and corporate customers, as well as the public.