

Firmly grasped business opportunities from operators

NetWork Optimization, Operation anD maintence services following network construction

Management Discussion & Analysis of Financial Conditions and Results of Operations

Overview

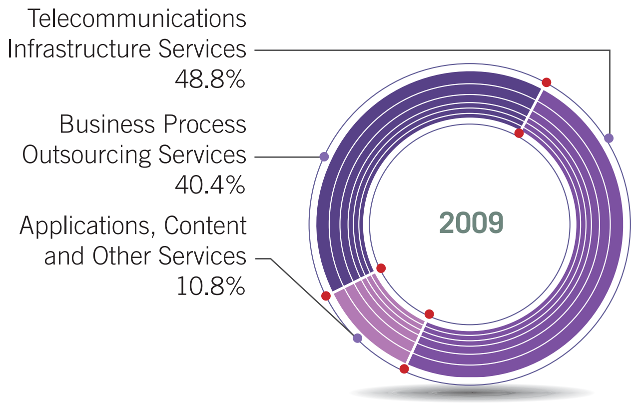
On 26 May 2009, the Company acquired 95.945% equity interests in Shanghai Tongmao Import & Export Co., Ltd and 51% equity interests in Guoxin Lucent Technologies Network Technologies Co., Ltd (collectively the "Target Interests"), for consideration of RMB64.16 million and RMB33.89 million respectively. Since the Group and the Target Interests are under common control of China Telecommunications Corporation, the Target Interests have been accounted for as a combination of entities under common control in a manner similar to pooling-of-interests. Accordingly, the assets and liabilities of the Target Interests have been accounted for at historical costs and the consolidated financial statements of the Company prior to the acquisition of the Target Interests have been restated to include the results of operations and assets and liabilities of the Target Interests on a combined basis. The considerations paid by the Group for the acquisitions of the Target Interests were accounted for as an equity transaction in the consolidated statement of changes in equity.

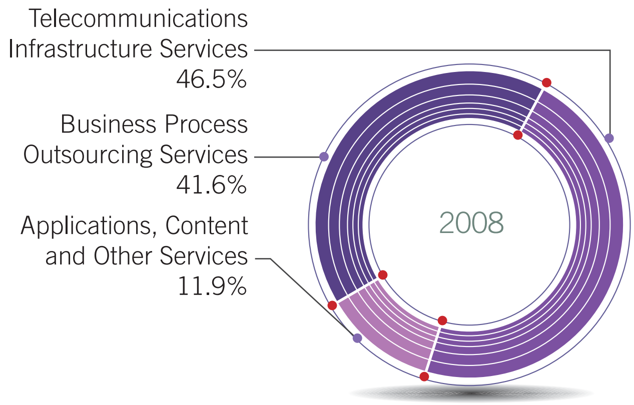
In 2009, the domestic telecommunications industry has entered the era of full services integrated operations. The whole Group, united as one, further focused on customer demand and strongly supported the 3G networks construction and full services integrated operations of the three telecommunications operators. The growth of all of our major businesses remained strong and we achieved favorable operating results. Our revenues amounted to RMB39,499.45 million, representing an increase of 19.7% from 2008. Profit attributable to equity shareholders of the Company amounted to RMB1,598.59 million, representing an increase of 20.5% from 2008. Basic earnings per share were RMB0.277, representing an increase of 18.9% from 2008. Free cash flow amounted to RMB1,207.14 million.

Revenues

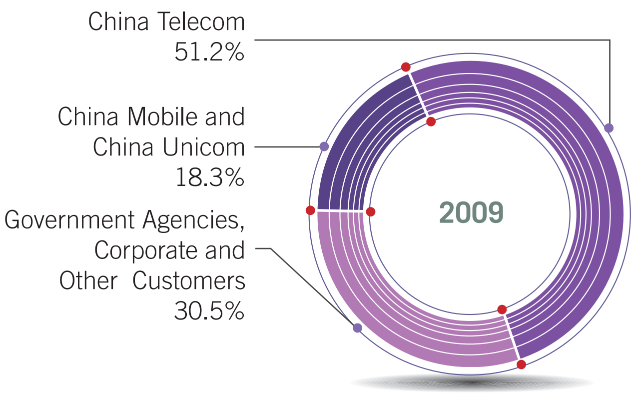
Our revenues in 2009 were RMB39,499.45 million, an increase of 19.7% from 2008. Among our businesses, revenue from telecommunications infrastructure services was RMB19,289.58 million, an increase of 25.8% from 2008; revenue from business process outsourcing services was RMB15,943.33 million, an increase of 16.0% from 2008; revenue from applications, content and other services was RMB4,266.54 million, an increase of 8.5% from 2008. Telecommunications infrastructure services and network maintenance services under business process outsourcing services were the major sources of our revenue growth in 2009. In terms of customer structure, the Group's revenues from the three telecommunications operators amounted to RMB27,472.73 million, representing 69.6% of the total revenues, an increase of 3.7 percentage points over last year.

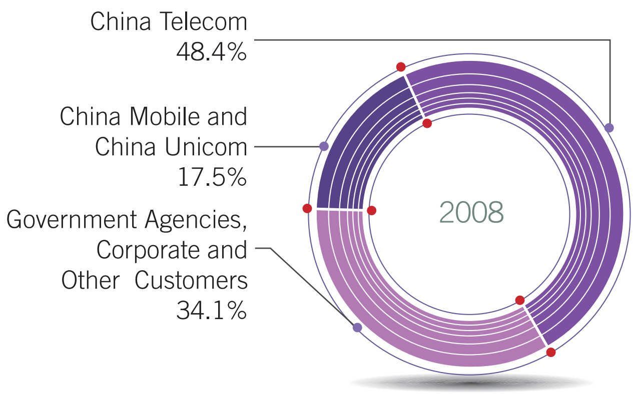
Business Mix





Customer Mix





The following table sets forth a breakdown of our revenues for 2008 and 2009, together with their respective rates of change:

	2009 RMB'000	2008 RMB'000	Percentage change
Telecommunications Infrastructure Services			
Design services	**4,021,105**	3,166,637	27.0%
Construction services	**14,086,311**	11,316,088	24.5%
Project supervision and management services	**1,182,163**	846,739	39.6%
	19,289,579	15,329,464	25.8%
Business Process Outsourcing Services			
Network maintenance	**3,484,132**	2,356,815	47.8%
Distribution of telecommunications services and products	**10,389,777**	9,433,761	10.1%
Facilities management	**2,069,417**	1,953,213	5.9%
	15,943,326	13,743,789	16.0%
Applications, Content and Other Services			
IT applications	**2,084,600**	2,076,912	0.4%
Internet service	**286,732**	361,170	(20.6%)
Voice VAS	**652,885**	578,071	12.9%
Other	**1,242,328**	915,966	35.6%
	4,266,545	3,932,119	8.5%
Total	**39,499,450**	33,005,372	19.7%

Telecommunications Infrastructure Services

In 2009, revenue from telecommunications infrastructure services was RMB19,289.58 million, which is our primary source of income, and accounted for 48.8% of our revenues. As the domestic telecommunications industry has entered into the era of full services integrated operations, all telecommunications operators significantly increased their investments in telecommunications network construction and optimization. The Group captured opportunities and strived to support the development of 3G network construction and full services integrated operations for the three telecommunications operators, China Telecom, China Mobile and China Unicom. The growth of our telecommunications infrastructure services business remained strong and revenue from this business increased by 25.8% over RMB15,329.46 million in 2008. The proportion of revenue from telecommunications infrastructure services to our total revenues increased by 2.3 percentage points.

Business Process Outsourcing Services

In 2009, revenue from business process outsourcing services was RMB15,943.33 million, representing an increase of 16.0% over RMB13,743.79 million for 2008. Business process outsourcing services accounted for 40.4% of our revenues, representing a decrease of 1.2 percentage points from 41.6% in 2008. Among our businesses, revenue from network maintenance was RMB3,484.13 million, representing an increase of 47.8% from 2008 and kept growing strongly. The growth was mainly due to telecommunications operators increasing their network capacity and outsourcing non-core businesses. In addition, the Group continued to strengthen the management of distribution of telecommunications services and products and optimize its business structure, such that the development of low-margin businesses was reasonably controlled and operating efficiency was improved. Revenues from distribution of telecommunications services and products amounted to RMB10,389.78 million, an increase of 10.1% from 2008. The proportion of revenue from the distribution of telecommunications services and products to our revenues decreased by 2.3 percentage points.

Applications, Content and Other Services

In 2009, revenue from applications, content and other service was RMB4,266.54 million, representing an increase of 8.5% over RMB3,932.12 million for 2008. As the primary focus of all telecommunications operators was on investments in 3G network construction in 2009, our revenues from both telecommunications infrastructure services and business process outsourcing services grew more rapidly. This led to the proportion of revenue from applications, content and other services to our revenues being reduced to 10.8%, representing a decrease of 1.1 percentage points from 11.9% in 2008. Among the businesses, revenue from IT applications amounted to RMB2,084.60 million and remained stable. Revenues from Internet services amounted to RMB286.73 million, representing a decrease of 20.6% from 2008. This was mainly due to the fact that the Group adjusted its business strategy and closed certain Internet cafés which historically had lower operational efficiency. Revenue from voice VAS was RMB652.89 million, representing a growth of 12.9% over 2008, which was mainly a result of the implementation of call centre business outsourcing by telecommunications operators.

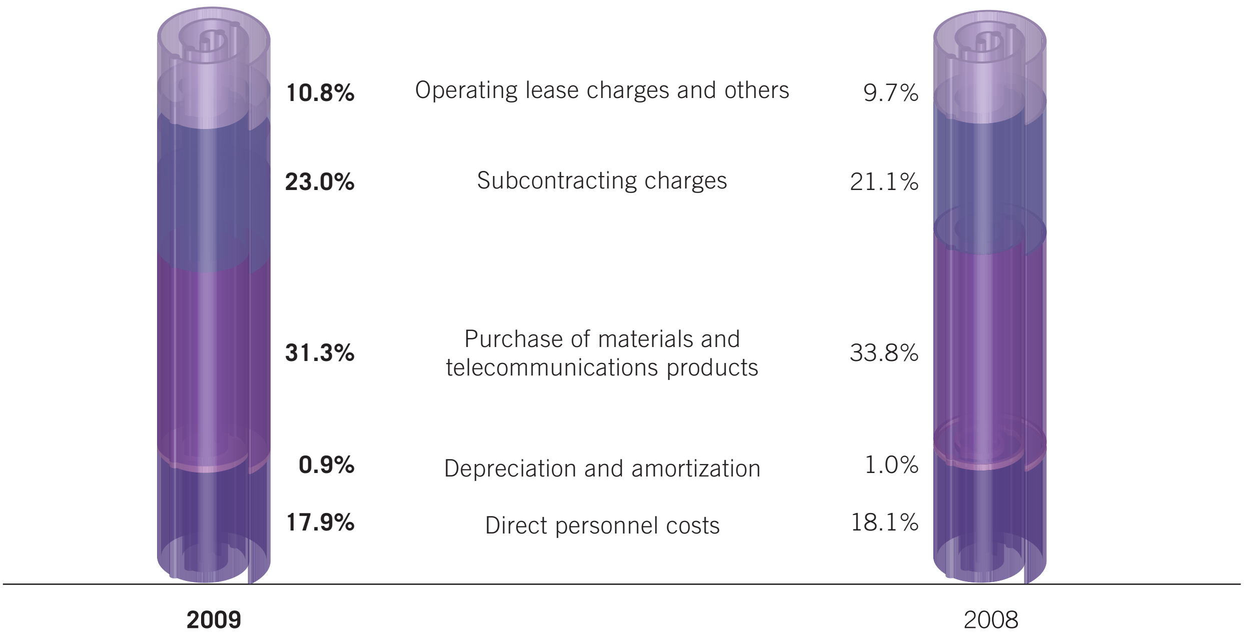
Cost of Revenues

Our cost of revenues in 2009 was RMB33,127.51 million, representing an increase of 19.9% from 2008 and accounting for 83.9% of our revenues.

The following table sets out a breakdown of our cost of revenues in 2008 and 2009 and their respective rates of change:

	2009 RMB'000	2008 RMB'000	Percentage change
Direct personnel costs	**7,073,351**	5,962,414	18.6%
Depreciation and amortization	**351,402**	336,629	4.4%
Purchase of materials and telecommunications products	**12,364,499**	11,167,207	10.7%
Subcontracting charges	**9,064,577**	6,970,705	30.0%
Operating lease charges and others	**4,273,684**	3,195,413	33.7%
Total cost of revenues	**33,127,513**	27,632,368	19.9%

Costs of revenues as the percentage of total revenues



Direct Personnel Costs

In 2009, direct personnel costs were RMB7,073.35 million, which accounted for 17.9% of our revenues and an increase of 18.6% over RMB5,962.41 million in 2008. With the rapid growth in business volume in 2009, the Group consistently applied reasonable control over its total headcount and subcontracted our low-end businesses, thereby minimizing the staff costs and avoiding related risk. The proportion of direct personnel costs to our revenues decreased by 0.2 percentage points compared to 2008.

Depreciation and Amortization

In 2009, depreciation and amortization amounted to RMB351.40 million, which accounted for 0.9% of our revenues and represented an increase of 4.4% over RMB336.63 million in 2008.

Purchase of Materials and Telecommunications Products

In 2009, the cost of purchasing materials and telecommunications products was RMB12,364.50 million, representing 31.3% of revenues and an increase of 10.7% over RMB11,167.21 million in 2008. In 2009, the Group strengthened its management in the business of distribution of telecommunications services and products and controlled the development of low-margin distribution businesses. This effectively lowered the growth of the cost of purchasing materials and telecommunications products. Its proportion to our revenues decreased by 2.5 percentage points compared to 2008.

Subcontracting Charges

In 2009, subcontracting charges were RMB9,064.58 million, which accounted for 23.0% of our revenues and represented an increase of 30.0% over RMB6,970.71 million in 2008. The increase in subcontracting charges was mainly derived from the business of telecommunications infrastructure services. As the business volume increased significantly in 2009, we outsourced certain of the low-end work to satisfy tight schedule demands of customers after taking into consideration of efficiency and benefits. Its proportion to our revenues increased by 1.9 percentage points compared to 2008.

Operating Lease Charges and Others

In 2009, operating lease charges and others were RMB4,273.68 million, which accounted for 10.8% of our revenues and represented an increase of 33.7% over RMB3,195.41 million in 2008. In 2009, the Group put more resources to explore market, satisfy customer demand and enhance service quality.

Gross Profit

In 2009, the Group's gross profit amounted to RMB6,371.94 million, representing an increase of RMB998.94 million from RMB5,373.00 million in 2008, representing an increase of 18.6%. The Group's gross profit margin in 2009 was 16.1%, representing a decrease of 0.2 percentage point over 16.3% in 2008. The Group was able to achieve a relatively stable gross profit margin level in 2009 through strengthening our project management, optimizing business structure and controlling staff cost.

Selling, General and Administrative Expenses

Our selling, general and administrative ("SG&A") expenses in 2009 were RMB4,691.51 million, representing an increase of 20.1% over RMB3,905.12 million in 2008, which accounted for 11.9% of revenues. In 2009, in order to capture opportunities, expand market share and enhance our core competitiveness, the Group put more resources into marketing and research and development. During the year, through enhancing our comprehensive budget management, we effectively controlled the growth of SG&A expenses. The proportion of SG&A expenses to our revenues was maintained at about the same level as in 2008.

Finance Costs

In 2009, the Group's finance costs was RMB88.44 million, represented a decrease of 49.8% over RMB176.33 million. The significant decrease was mainly due to the fact that the Group strengthened the centralized cash management and the cooperation with banks, improved our efficiency in cash utilization and repaid certain short term borrowings.

Income Tax

Certain of our subsidiaries were recognized as new and high-technology enterprises and were entitled to a preferential income tax rate of 15%. Our subsidiaries in Shenzhen, Zhuhai, Xiamen and Hainan Special Economic Zones were entitled to an income tax rate of 20%. Apart from these companies, the Company and other subsidiaries of the Group are subject to an income tax rate of 25%. The income tax of the Group in 2009 was RMB427.36 million and our effective tax rate was 21.0%, representing a decrease of 2.1 percentage point over 23.1% in 2008. This was mainly due to the fact that certain of our subsidiaries successfully applied for the preferential income tax treatment for new and high-technology enterprises. The difference between our effective tax rate and the statutory tax rate was mainly due to the effect of the aforementioned preferential tax rate treatment of our subsidiaries.

Profit Attributable to Equity Shareholders of the Company

In 2009, profit attributable to equity shareholders of the Company was RMB1,598.59 million, an increase of 20.5% over RMB1,326.77 million in 2008 which was slightly higher than the revenue growth, and we therefore achieved the simultaneous growth in scale and efficiency.

Capital Expenditure

We implemented stringent budget management over capital expenditure, and therefore adjusted our capital expenditure plan according to the changes of market condition. In 2009, our capital expenditure amounted to RMB795.69 million, representing an increase of 12.5% over RMB707.14 million in 2008. The capital expenditure in 2009 represented 2.0% of our revenues, maintained at the similar level as in 2008. Our capital expenditure included the purchases of production facilities and equipment, machinery and meters, plant and office buildings, intangible assets and other operating assets.

Cash Flow

Our net cash inflow in 2009 was RMB336.68 million whereas that in 2008 was RMB1,769.48 million. As at the end of 2009, our cash and cash equivalents amounted to RMB8,870.42 million, of which 96.9% was denominated in Renminbi.

The following table sets out our cash flow positions in 2008 and 2009, respectively:

	2009 **RMB'000**	2008 RMB'000
Net cash generated from operating activities	**2,062,227**	1,947,733
Net cash used in investing activities	**(814,115)**	(44,778)
Net cash used in financing activities	**(911,437)**	(133,480)
Net increase in cash and cash equivalents	**336,675**	1,769,475

In 2009, net cash generated from operating activities was RMB2,062.23 million, an increase of RMB114.50 million from RMB1,947.73 million in 2008. The increase in net cash generated from operating activities was mainly cash generated from rapid revenue growth, and this not only supported the rapid development of the Group's domestic and overseas business but also provided a small amount of excess cash.

In 2009, net cash used in investing activities was RMB814.12 million, an increase of RMB769.34 million from RMB44.78 million in 2008. This was mainly because that the amount in 2008 included the cash paid for the acquisition of China International Telecommunications Construction Corporation and the cash brought into our Group by it. Cash used in investing activities in 2009 mainly comprised the consideration paid for the acquisition of the Target Interests and capital expenditure.

In 2009, net cash used in financing activities was RMB911.44 million, an increase of RMB777.96 million from RMB133.48 million in 2008. This was mainly because the Group strengthened its cash management, enhanced our cash utilization efficiency and repaid certain short term borrowings.

Working Capital

As at the end of 2009, working capital (i.e. non-cash current assets minus operating current liabilities) deficit was RMB218.41 million, while working capital surplus was RMB107.40 million in 2008, mainly because we strengthened our accounts receivable management and obtained better credit terms.

Indebtedness

As at the end of 2009, total indebtedness of the Group was RMB1,268.28 million, and most of them were fixed interest rate loans and denominated in Renminbi. Our indebtedness decreased by RMB725.15 million from RMB1,993.43 million at the year end of 2008.

As at the end of 2009, our gearing ratio(1) was 8.8%, a decrease of 5.4 percentage points from 14.2% in 2008.

Contractual Obligations

The following table sets out our contractual obligations as at 31 December 2009:

	Total RMB'000	**2010** RMB'000	**2011** RMB'000	**2012** RMB'000	**2013** RMB'000	**2014 and after** RMB'000
Short-term debt	1,268,280	1,268,280	–	–	–	–
Long-term debt	–	–	–	–	–	–
Operating lease commitments	241,164	114,187	56,632	35,940	18,120	16,285
Capital commitments	217,083	217,083	–	–	–	–
Of which:						
Authorized and contracted for	100,064	100,064	–	–	–	–
Authorized but not contracted for	117,019	117,019	–	–	–	–
Total of contractual obligations	1,726,527	1,599,550	56,632	35,940	18,120	16,285

(1) Gearing ratio equals to total interest-bearing debts divided by the sum of total interest-bearing debts and equity attributable to equity shareholders of the Company at the end of the financial year.

Exchange Rate

Most of our revenues and expenses are settled in Renminbi and therefore the risks associated with foreign currency exchange rates have no significant impact on our business performance. As at the end of 2009, the balance of our cash and cash equivalents in foreign currencies accounted for 3.1% of our total cash and cash equivalents, of which 1.4% and 1.1% were denominated in US dollars and Hong Kong dollars respectively.

Acquisitions and Integration

In May 2009, the Group completed its acquisition of the Target Interests. After completion of the acquisition, through effective integration, the Group enhanced the management standard and operation efficiency of the Target Interests and their operating results achieved our target. The acquisition is a complement to the Group's existing business as a specialized telecommunications support service provider. This assisted our provision of better service to telecommunications operators and strengthened our leading market position and competitiveness. Furthermore, the Group could reap the benefits from the increasing demand for our services following China's entering into the 3G era in early 2009.