MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

OVERVIEW

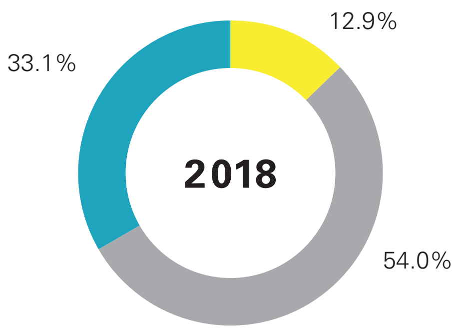
In 2018, the Group adhered to its overall roadmap of "value-driven, seeking steady yet progressive growth and high-quality development". By capturing new opportunities in digitalization, fostering the new brand of "Smart Comservice" and continuing to transform its growth momentum, the Group made the leap from a ten-billion enterprise to a hundred-billion enterprise. Total revenues for the year amounted to RMB106,177 million, representing an increase of 12.3% as compared to 2017. Profits attributable to the equity shareholders of the Company was RMB2,901 million, representing an increase of 6.9% as compared to RMB2,714 million in 2017, with basic earnings per share amounted to RMB0.419. Free cash flow was RMB3,613 million, and cash conversion ratio was 146.9%, remaining at a healthy level continuously.

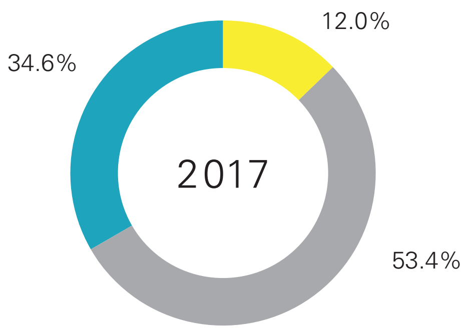
TOTAL REVENUES

The Group's total revenues in 2018 amounted to RMB106,177 million, representing an increase of 12.3% as compared to 2017. From the business perspective, the revenue from telecommunications infrastructure ("TIS") services was RMB57,359 million, representing a year-on-year growth of 13.6%; the revenue from business process outsourcing ("BPO") services was RMB35,103 million, representing a year-on-year increase of 7.1%, of which the revenues from Core BPO services (i.e. excluding products distribution business) was RMB30,220 million, representing a year-on-year increase of 17.1%; and the revenue from applications, content and other ("ACO") services was RMB13,715 million, representing a year-on-year growth of 21.4%. The Group continuously improved the delivery capabilities of TIS services, and extended its competitive industrial capacity to different markets, making TIS services the biggest driver of its overall revenue growth. Meanwhile, the Group aggressively promoted its smart services, which in turn stimulated the growth of its software development and system integration businesses, development of the ACO services expedited and became the fastest growing business segment of the year. The Group continued to optimize its Core BPO services, aiming to turn it into a sustainable and recurrent business, with the related revenue maintaining at double-digit growth.

From the market perspective, the incremental revenue from the domestic non-telecom operator market surpassed those generated from the domestic telecommunications operator market in 2018, and the revenue from such market amounted to RMB33,317 million, representing a year-on-year increase of 25.0%, in which, revenue from the Core Businesses of such market amounted to RMB29,701 million, representing a rapid year-on-year increase of 33.9%. Revenue from the domestic telecommunications operator market amounted to RMB69,705 million, representing a year-on-year growth of 7.1%; and revenue from the overseas market amounted to RMB3,155 million, representing a year-on-year increase of 11.2%. In 2018, the Group fully exploited the demands arising from the Digital Economy and Smart Society of the domestic non-telecom operator customers, such as governments and enterprises, and businesses from such market became the main growth momentum of the Group's total revenues. Meanwhile, the Group kept abreast of the network construction of the domestic telecommunications operators and endeavoured to increase its market share, and also captured the opportunity of OPEX business of the domestic telecommunications operators through putting more efforts on the expansion of Network Maintenance business, and constantly promoting the synergistic operation of supply chain and general facilities management businesses, thus effectively alleviating the impact of the decrease in the telecommunications operators' CAPEX on the development of the Group.

BUSINESS REVENUE MIX





Telecommunications Infrastructure Services | Business Process Outsourcing Services | Applications, Content and Other Services

The following table sets forth a breakdown of our total revenues for 2017 and 2018, together with their respective changes:

	2018 RMB'000	2017 RMB'000	Change
Telecommunications Infrastructure Services			
Design services	**10,605,020**	10,239,148	3.6%
Construction services	**42,862,805**	36,668,312	16.9%
Project supervision and management services	**3,891,611**	3,603,528	8.0%
	57,359,436	50,510,988	13.6%
Business Process Outsourcing Services			
Management of infrastructure for information technology (Network Maintenance)	**14,793,165**	12,829,513	15.3%
General facilities management	**5,277,821**	4,554,889	15.9%
Supply chain	**10,148,648**	8,424,053	20.5%
Sub-total of Core BPO Services	**30,219,634**	25,808,455	17.1%
Products distribution	**4,883,188**	6,955,230	–29.8%
	35,102,822	32,763,685	7.1%
Applications, Content and Other Services			
System integration	**7,372,535**	5,789,503	27.3%
Software development and system support	**2,501,901**	2,048,496	22.1%
Value added services	**1,934,382**	1,570,458	23.2%
Others	**1,905,561**	1,889,281	0.9%
	13,714,379	11,297,738	21.4%
Total	**106,176,637**	94,572,411	12.3%

Telecommunications Infrastructure Services

In 2018, the Group's revenue from TIS services amounted to RMB57,359 million, representing an increase of 13.6% as compared to RMB50,511 million in 2017. TIS services was the primary source of revenue and accounted for 54.0% of our total revenues, representing an increase of 0.6 percentage point from 53.4% in 2017. As to the customer structure of the TIS services, the Group's TIS revenue from domestic telecommunications operators amounted to RMB40,325 million and accounted for 70.3% of the total TIS revenues, representing a decrease of 6.2 percentage points from last year. The aggregate TIS revenues from domestic non-telecom operator customers and overseas customers amounted to RMB17,034 million and accounted for 29.7% of the total TIS revenues, representing an increase of 6.2 percentage points from last year, whereas the increase in proportion was driven by domestic non-telecom operator customers.

In 2018, the Group's TIS revenue from domestic telecommunications operators increased by 4.3% over 2017. The Group persisted in strengthening project management and improving delivery quality, and its TIS revenue from the domestic telecommunications operator customers recorded a steady growth despite the CAPEX decrease from those customers. Meanwhile, the aggregate TIS revenues from domestic non-telecom operator customers and overseas customers increased by 43.6% over 2017, in which the TIS revenue from domestic non-telecom operator customers recorded a significant year-on-year growth of 50.8%, showing a remarkably enhanced growth momentum, as a result of which effectively alleviated the impacts from changes in network investments of the domestic telecommunications operators.

Business Process Outsourcing Services

In 2018, the Group's revenue from BPO services amounted to RMB35,103 million, representing an increase of 7.1% as compared to RMB32,763 million in 2017, accounting for 33.1% of our total revenues, a decrease of 1.5 percentage points as compared to 34.6% in 2017. Excluding the products distribution business, revenue from the Core BPO businesses amounted to RMB30,220 million, representing a year-on-year growth of 17.1%. Our Core BPO businesses achieved a rapid growth mainly due to our enhanced efforts in developing the OPEX business of the domestic telecommunications operators. In terms of customer structure of the BPO services, the BPO revenue from the domestic telecommunications operators amounted to RMB23,514 million, representing an increase of 10.0% over 2017, and accounting for 67.0% of the total revenues from the BPO services, representing an increase of 1.8 percentage points over 2017. The aggregate BPO revenues from the domestic non-telecom operator customers and overseas customers amounted to RMB11,589 million, representing an increase of 1.7% over 2017, accounted for 33.0% of the total revenues from the BPO services, representing a decrease of 1.8 percentage points over 2017.

In 2018, among each of the business under the Group's BPO services, revenue from the Network Maintenance business maintained a favourable growth and amounted to RMB14,793 million, representing an increase of 15.3% as compared to 2017, which is primarily due to the Group's focus on the OPEX business and the continuously increasing operation outsourcing demand of domestic telecommunications operators. The Group's capabilities for undertaking nation-wide integrated business and synergistic operation of supply chain business have been gradually enhanced, and the revenue from such business amounted to RMB10,149 million, representing an increase of 20.5% as compared to 2017. Revenue from the general facilities management service amounted to RMB5,278 million, representing an increase of 15.9% as compared to 2017, maintaining a favourable growth momentum. Besides, the Group adhered to the principle of high-quality development and proactively controlled products distribution business with low efficiency, and revenue from the products distribution business decreased by 29.8% as compared to 2017 and amounted to RMB4,883 million.

Applications, Content and Other Services

In 2018, the Group's revenue from ACO services amounted to RMB13,715 million, representing an increase of 21.4% as compared to RMB11,298 million in 2017, making it the fastest-growing business segment for the year. The revenue from ACO services accounted for 12.9% of the Group's total revenues, representing an increase of 0.9 percentage point from 12.0% in 2017, which has been constantly growing for three consecutive years. In terms of the customer structure of ACO services, the Group's ACO revenue from domestic telecommunications operators amounted to RMB5,866 million and accounted for 42.8% of the total ACO revenues, representing a decrease of 2.0 percentage points from the corresponding period of last year. Aggregate ACO revenues from domestic non-telecom operator customers and overseas customers amounted to RMB7,849 million, accounting for 57.2% of the total ACO revenues, representing an increase of 2.0 percentage points from the corresponding period of last year, which was driven by the domestic non-telecom operator customers.

In 2018, the Group adapted to the national strategies, including "Cyberpower", "Digital China" and "Smart Society", as well as the "Belt and Road" Initiative, and further enriched and optimized its smart solutions for different industries by consolidating its internal and external resources, strengthening synergistic cooperation, and leveraging advanced technologies such as Big Data, Cloud Computing, and IoT. Aggregate ACO revenues from the domestic non-telecom operator customers and overseas customers witnessed a rapid growth of 25.8% over 2017. With the Group's enhanced efforts in developing the domestic non-telecom operator customers, both the revenue and incremental revenue contribution of those customers from ACO services have surpassed those of the domestic telecommunications operators. ACO revenue from domestic telecommunications operators increased by 15.9% over 2017, maintaining a steady growth.

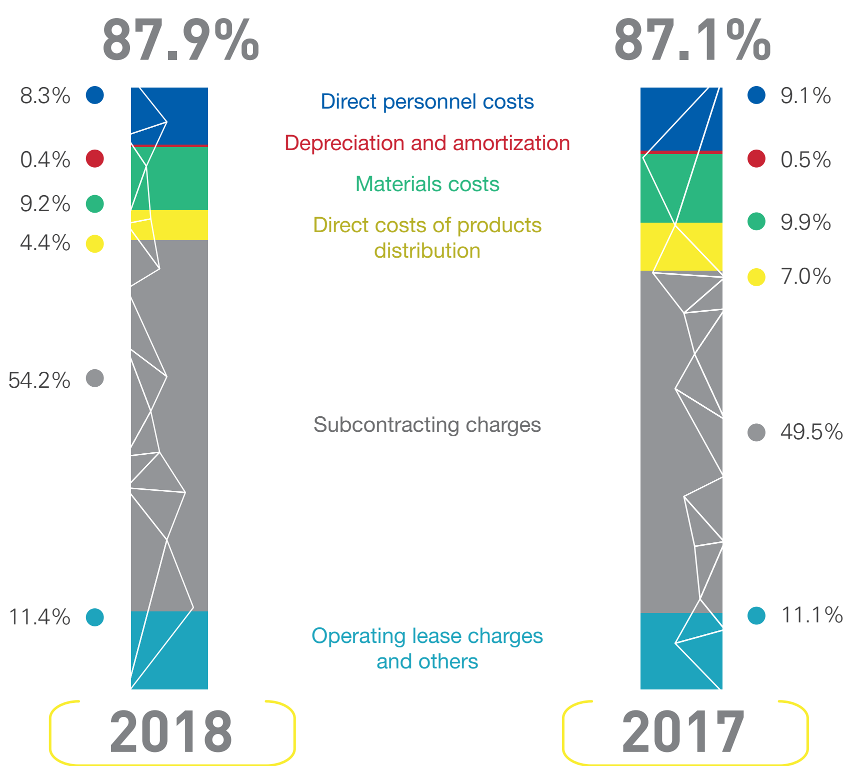
COST OF REVENUES

The Group's cost of revenues in 2018 amounted to RMB93,292 million, representing an increase of 13.3% from 2017 and accounting for 87.9% of the total revenues.

The following table sets out a breakdown of the Group's cost of revenues in 2017 and 2018 and their respective changes:

	2018 RMB'000	2017 RMB'000	Change
Direct personnel costs	**8,747,317**	8,647,493	1.2%
Depreciation and amortization	**466,096**	472,621	–1.4%
Materials costs	**9,783,239**	9,327,654	4.9%
Direct costs of products distribution	**4,629,177**	6,594,772	–29.8%
Subcontracting charges	**57,555,216**	46,858,020	22.8%
Operating lease charges and others	**12,110,626**	10,459,491	15.8%
Total cost of revenues	**93,291,671**	82,360,051	13.3%

COST OF REVENUES AS A % OF TOTAL REVENUES



Direct Personnel Costs

In 2018, direct personnel costs amounted to RMB8,748 million, representing an increase of 1.2% from RMB8,647 million in 2017. Direct personnel costs as a proportion to our total revenues was 8.3%, representing a decrease of 0.8 percentage point from 2017. With the growth in its business volume in 2018, the Group made use of outsourcing resources reasonably, strictly controlled its total headcount and staff costs, thereby improving its labour productivity.

Depreciation and Amortisation

In 2018, depreciation and amortisation were RMB466 million, representing a decrease of 1.4% from RMB473 million in 2017. Depreciation and amortisation as a proportion to our total revenues was 0.4%.

Materials Costs

In 2018, materials costs amounted to RMB9,783 million, representing an increase of 4.9% as compared to RMB9,328 million in 2017. Materials costs as a proportion to our total revenues was 9.2%, representing a decrease of 0.7 percentage point from 2017. The increase in materials costs was mainly attributable to the increase in relevant materials costs caused by the growth of our system integration and supply chain services.

Direct Costs of Products Distribution

In 2018, the direct costs of products distribution amounted to RMB4,629 million, representing a decrease of 29.8% as compared to RMB6,595 million in 2017. Direct costs of products distribution as a proportion to our total revenues was 4.4%, representing a decrease of 2.6 percentage points over 2017. The significant decrease in the direct costs of products distribution was mainly because the Group proactively controlled the development of certain low efficiency products distribution business.

Subcontracting Charges

In 2018, subcontracting charges were RMB57,555 million, representing an increase of 22.8% as compared to RMB46,858 million in 2017. Subcontracting charges as a proportion to our total revenues was 54.2%, representing an increase of 4.7 percentage points over 2017. The increase in subcontracting charges was mainly from the construction and Network Maintenance businesses. The Group has been transforming from the labour-intensive operation model to management and technology-intensive operation model. In order to meet the need for transformation and the demand for total headcount control, the Group focused on high-end businesses and promoted subcontracting of low-end businesses. In addition, the Group undertook more turnkey projects in the domestic non-telecom operator market, in which the turnkey projects have more needs for subcontracting for certain professional work.

Operating Lease Charges and Others

In 2018, operating lease charges and others were RMB12,111 million, representing an increase of 15.8% over RMB10,459 million in 2017. Operating lease charges and others as a proportion to our total revenues was 11.4%, representing an increase of 0.3 percentage point over 2017. The increase in costs was mainly due to the increase in technical service expenses under other expenses in order to support the business development of the Group.

GROSS PROFIT

In 2018, the Group recorded gross profit of RMB12,885 million, representing an increase of 5.5% over RMB12,212 million in 2017. The Group's gross profit margin in 2018 was 12.1%, representing a decrease of 0.8 percentage point from 12.9% in 2017. In 2018, there was a decline in gross profit margin of the Group due to various factors, including the decrease in unit prices of certain businesses from domestic telecommunications operator market and the increase in certain costs that were characterized as fixed in nature, such as labour-related costs. In addition, due to the fact that the development in the domestic non-telecom operator market is still in the preliminary introductory phase, the gross profit margin were affected to a certain extent with the rapid increase of revenue scale. In the meantime, the Group continued to optimize its revenue structure in 2018. Revenue from the Core Businesses as a proportion to our total revenues was 95.4%, representing an increase of 2.7 percentage points as compared to the previous year, thereby alleviating the impacts brought by the above factors on gross profit margin to a certain extent. Through continuous transformation and business upgrade, the Group will endeavour to increase the proportion of smart businesses and improve gross profit margin.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

In 2018, the selling, general and administrative expenses of the Group were RMB10,611 million, representing an increase of 7.3% as compared to RMB9,885 million in 2017. The selling, general and administrative expenses as a proportion of our total revenues was 10.0%, representing a decrease of 0.5 percentage point from 2017. The main reason for the increase in selling, general and administrative expenses was the increased investment on research and development as well as sales and marketing during the year to support the Group's direction of transformation towards digitalization and cultivate the brand of "Smart Comservice", so as to help expand its businesses.

FINANCE COSTS

In 2018, the finance costs of the Group were RMB25 million (2017: RMB47 million), which was lower than that of 2017. It was mainly due to the decrease in the relevant interest expenses as a result of the redemption of the convertible preference shares by one of the Group's subsidiaries in 2017.

INCOME TAX

In 2018, the income tax of the Group was RMB497 million and its effective tax rate was 14.5%, representing a decrease of 0.4 percentage point from 14.9% in 2017. The difference between the Group's effective tax rate and the statutory tax rate was mainly due to the preferential income tax rate treatment enjoyed by certain subsidiaries, which are classified as new and high-technology enterprises, and the preferential policy of tax deduction before income tax for research and development expenses.

In 2018, certain subsidiaries of the Group that fall under the scope of new and high-technology enterprises were entitled to a preferential income tax rate of 15%. Certain enterprises in the western China were entitled to the preferential policies for Western Development Program. Apart from these subsidiaries, the Company and other domestic subsidiaries of the Group were mainly subject to an income tax rate of 25%. The overseas subsidiaries of the Group were subject to different tax rates in various countries.

PROFIT ATTRIBUTABLE TO EQUITY SHAREHOLDERS OF THE COMPANY AND BASIC EARNINGS PER SHARE

In 2018, profit attributable to equity shareholders of the Company was RMB2,901 million, representing an increase of 6.9% over RMB2,714 million in 2017. Profit attributable to equity shareholders of the Company accounted for 2.7% of our total revenues, which slightly decreased as compared to 2017. Basic earnings per share of the Company were RMB0.419, representing an increase of 6.9% as compared to RMB0.392 in 2017.

CAPITAL EXPENDITURE

The Group implemented stringent budget management over capital expenditure, and made adjustments according to changes in market condition. In 2018, capital expenditure amounted to RMB824 million, representing a decrease of 10.5% over RMB921 million in 2017. The capital expenditure in 2018 accounted for 0.8% of the total revenues, representing a decrease of 0.2 percentage point over 2017. The capital expenditure of the Group included the purchases of production facilities and equipment, machinery and meters, plant and office buildings, intangible assets and other operating assets.

CASH FLOW

The Group recorded a net cash inflow of RMB2,824 million in 2018, as compared with a net cash outflow of RMB21 million in 2017. Such change was mainly due to the decrease of cash used in investing activities during the reporting period. As at the end of 2018, the balance of cash and cash equivalents of the Group amounted to RMB16,106 million, of which 95.3% was denominated in Renminbi.

The following table sets out our cash flow positions in 2017 and 2018, respectively:

	2018 RMB'000	2017 RMB'000
Net cash generated from operating activities	**4,260,971**	6,964,245
Net cash used in investing activities	**(550,886)**	(5,683,712)
Net cash used in financing activities	**(885,710)**	(1,301,884)
Net increase/(decrease) in cash and cash equivalents	**2,824,375**	(21,351)

In 2018, net cash generated from operating activities was RMB4,261 million, representing a decrease of RMB2,703 million from RMB6,964 million in 2017. The change in operating cash flow was mainly because of the high base effect after substantial increases in the previous years, and it returned to a relatively normal level in 2018.

In 2018, net cash used in investing activities was RMB551 million, representing a decrease of RMB5,132 million from RMB5,683 million in 2017. The decrease was mainly attributable to the utilization of part of the fund to purchase short-term wealth management products and place in banks as structured deposits since 2017, but there was no further increase in the scale in 2018 considering the overall arrangement of the Group.

In 2018, net cash used in financing activities was RMB886 million, representing a decrease of RMB416 million from RMB1,302 million in 2017. The decrease was mainly due to the combined impact of the convertible preference shares redeemed by one of the subsidiaries of the Group in 2017 and the increase in borrowings for overseas business expansion in 2018.

WORKING CAPITAL

As at the end of 2018, the Group's working capital (i.e. current assets net of current liabilities) was RMB21,783 million, representing an increase of RMB1,005 million from RMB20,778 million in 2017. The increase in working capital was mainly due to the expansion of the Group's business and effective fund management which led to an increase in operating cash flow and current assets.

ASSETS AND LIABILITIES

The Group continued to maintain its solid financial position. As at the end of 2018, the Group's total assets was RMB80,926 million, representing an increase of RMB10,191 million from RMB70,735 million in 2017. Total liabilities was RMB48,097 million, representing an increase of RMB6,182 million from RMB41,915 million in 2017. The liabilities-to-assets ratio was 59.4%, which is basically the same as that of 59.3% at the end of 2017.

As at the end of 2018, among the current assets, there was an amount of RMB5,047 million under financial assets at fair value through profit or loss in relation to the purchase of wealth management products and structure deposits by the Group, in which such amount was remained at basically the same level as compared to the end of 2017. As at the end of 2017, an amount of RMB3,750 million under prepayments and other current assets and an amount of RMB1,262 million under financial assets at fair value through profit of loss were recorded in accordance with the actual nature of the products purchased. For details, please refer to note 31 and note 32 in the audited financial statement of this annual report.

As at the end of 2018, among the non-current assets, there was an amount of RMB3,738 million under equity instruments at fair value through other comprehensive income in relation to the equity instrument held for long-term strategic purposes and not held for trading, whereas such item was classified under available-for-sale financial assets with an amount of RMB852 million at the end of 2017. There was no new investment made during the year of 2018, and the reclassification and the change in value during 2018 was mainly due to the adoption of IFRS 9 (Financial Instruments) which changed the classification and the measurement method. For details, please refer to note 3, note 23 and note 24 in the audited financial statement of this annual report.

As at the end of 2018, there were reclassifications among the items of accounts and bills receivable (net) as well as contract assets (net) under the current assets, and also reclassifications among the items of contract liabilities, receipts in advance for contract work as well as accrued expenses and other payables under the current liabilities due to the adoption of IFRS 9 (Financial Instruments) and IFRS 15 (Revenue from Contracts with Customers). For details, please refer to note 3, note 28, note 30, note 37 and note 38 in the audited financial statement of this annual report.

INDEBTEDNESS

As at the end of 2018, total indebtedness of the Group was RMB471 million, representing an increase of RMB144 million from RMB327 million as at the end of 2017. Indebtedness of the Group was mainly denominated in US dollar, of which Renminbi loan accounted for 2.8% and US dollar loan accounted for 85.5%; and of which 21.3% was the loans with a fixed interest rate and 78.7% was those with a floating interest rate.

As at the end of 2018, our gearing ratio[6] was 1.4%, representing an increase of 0.3 percentage point from 1.1% as at the end of 2017.

CONTRACTUAL OBLIGATIONS

The following table sets out our contractual commitments as at 31 December 2018:

	Total RMB'000	**2019** RMB'000	**2020** RMB'000	**2021** RMB'000	**2022** RMB'000	**2023 and after** RMB'000
Short-term debt	462,003	462,003	–	–	–	–
Long-term debt	8,922	–	8,922	–	–	–
Operating lease commitments	1,301,802	508,960	283,124	175,383	97,493	236,842
Contracted for but not provided capital commitments	500,340	500,340	–	–	–	–
Total of contractual obligations	2,273,067	1,471,303	292,046	175,383	97,493	236,842

EXCHANGE RATE

Most of the Group's revenues and expenses are denominated in Renminbi. As at the end of 2018, the balance of the Group's cash and cash equivalents in foreign currencies accounted for 4.7% of the balance of its total cash and cash equivalents, of which 1.9% and 0.5% were denominated in US dollars and Hong Kong dollars, respectively.

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

Enhancing

CAPABILITIES ACCUMULATION AND CAPABILITIES ENABLING

to develop market

SYNERGISTICALLY

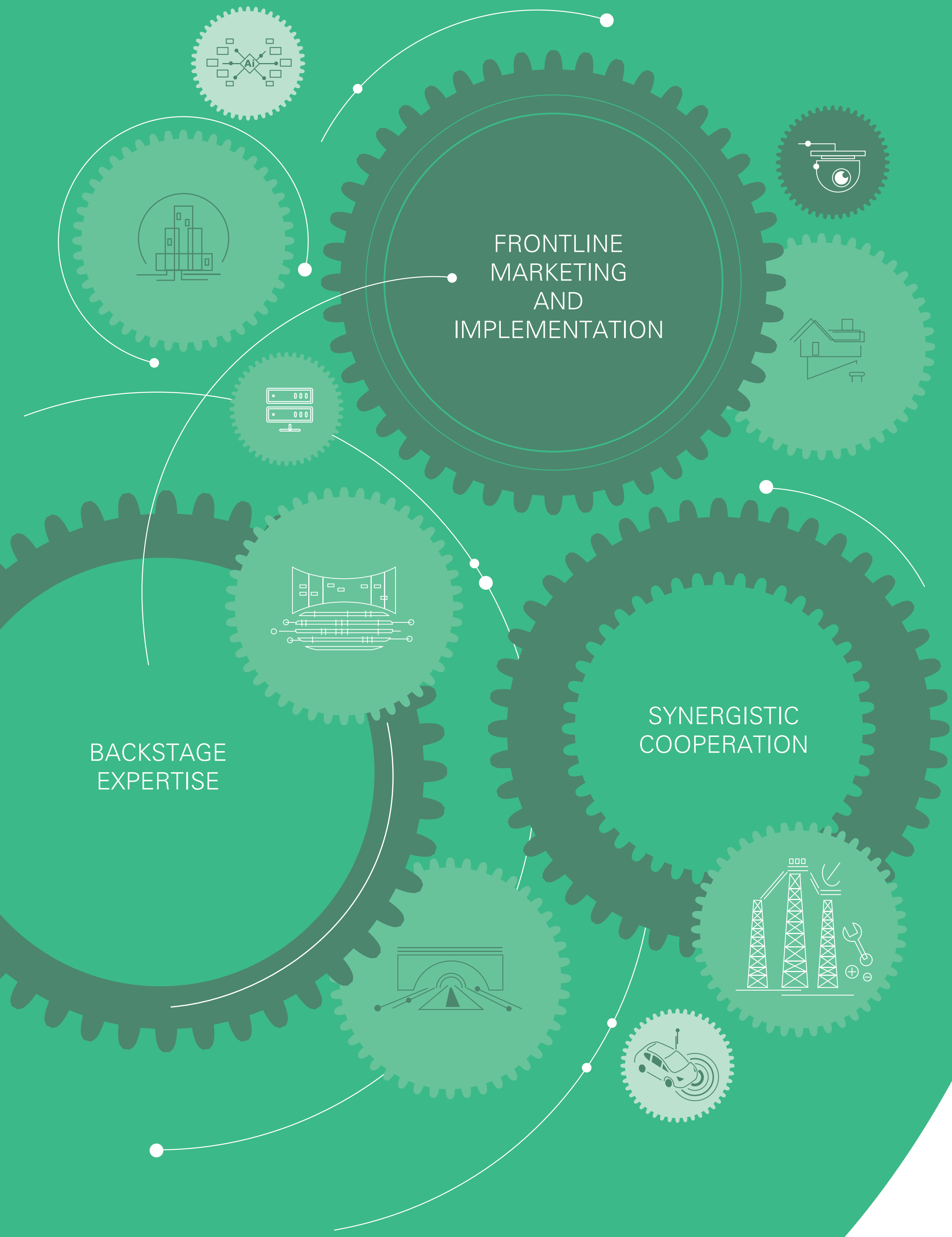
LEVERAGING ON LOCAL

FRONTLINE MARKETING AND IMPLEMENTATION CAPABILITIES

MOBILIZING DIFFERENT

BACKSTAGE TECHNICAL EXPERTISE FROM EACH PROVINCE

EXERTING SYNERGIES OF **THE GROUP AS A WHOLE**


FRONTLINE
MARKETING
AND
IMPLEMENTATION
SYNERGISTIC
COOPERATION
BACKSTAGE
EXPERTISE