CHINA SOUTHERN AIRLINES CO LTD
Form 20-F
June 30, 2003

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As filed with the Securities and Exchange Commission on [June 30, 2003]

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

o *REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934*

OR

x *ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934*

For the fiscal year ended December 31, 2002

OR

o *TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934*

Commission file number: 1-14660

(Exact name of Registrant as specified in its charter)

CHINA SOUTHERN AIRLINES COMPANY LIMITED

(Translation of Registrant s name into English)

THE PEOPLE S REPUBLIC OF CHINA
(Jurisdiction of incorporation or organization)

BAIYUN INTERNATIONAL AIRPORT
GUANGZHOU
PEOPLE S REPUBLIC OF CHINA

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class:	***Name of each exchange on which registered:***
Ordinary H Shares of par value RMB1.00 per share represented by American Depositary Shares	*New York Stock Exchange, Inc.*

Securities registered or to be registered pursuant to Section 12(g) of the Act: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report: 2,200,000,000 ordinary Domestic Shares of par value RMB1.00 per share and 1,174,178,000 ordinary H Shares of par value RMB1.00 per share were issued and outstanding as of December 31, 2002.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes x *No* o

Indicate by check mark which financial statement item the Registrant has elected to follow.

Item 17 o *Item 18* x

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FORWARD-LOOKING STATEMENTS

This Annual Report contains forward-looking statements. These statements appear in a number of different places in this Annual Report. A forward looking statement is usually identified by the use in this Annual Report of certain terminology such as estimates , projects , expects , intends , believes , plans , anticipates , or their negatives or other comparable words. Also look for discussions of strategy that involve risks and uncertainties. Forward-looking statements include statements regarding the outlook for the Company s future operations, forecasts of future costs and expenditures, evaluation of market conditions, the outcome of legal proceedings (if any), the adequacy of reserves, or other business plans. You are cautioned that such forward-looking statements are not guarantees and involve risks, assumptions and uncertainties. The Company s actual results may differ materially from those in the forward-looking statements due to risks facing the Company or due to actual facts differing from the assumptions underlying those forward-looking statements.

Some of these risks and assumptions, in addition to those identified under Item 3, Key Information Risk Factors, include:

- general economic and business conditions, including changes in interest rates;
- prices and other economic conditions;
- natural phenomena;
- actions by government authorities, including changes in government regulation;
- the Company s relationship with CSAHC (formerly the SA Group);
- uncertainties associated with legal proceedings;
- technological development;
- future decisions by management in response to changing conditions;
- the Company s ability to execute prospective business plans; and
- misjudgments in the course of preparing forward-looking statements.

The Company advises you that these cautionary remarks expressly qualify in their entirety all forward-looking statements attributable to the Company, the Group, and persons acting on their behalf.

INTRODUCTORY NOTE

In this Annual Report, unless the context indicates otherwise, the Company means China Southern Airlines Company Limited, a joint stock company incorporated in China on March 25, 1995, the Group means the Company and its consolidated subsidiaries, and CSAHC means China Southern Air Holding Company, the Company s parent company which holds a 65.2% controlling interest in the Company (Southern Airlines (Group) changed its official name to China Southern Air Holding Company on October 11, 2002.).

References to China or the PRC are to the People s Republic of China, excluding Hong Kong, Macau and Taiwan. References to Renminbi or RMB are to the currency of China, references to U.S. dollars , $ or US$ are to the currency of the United States of America (the U.S. or Un States), and reference to HK$ is to the currency of Hong Kong. Reference to the Chinese Government is to the national government of China. References to Hong Kong or Hong Kong SAR are to the Hong Kong Special Administrative Region of the People s Republic of China. References to Macau or Macau SAR are to the Macau Special Administrative Region of the People s Republic of China.

The Company presents its financial statements in Renminbi. The consolidated financial statements of the Company as of December 31, 2001 and 2002, and the consolidated financial statements for the years ended December 31, 2000, 2001 and 2002, together with the notes thereto (collectively, the Financial Statements), have been prepared in accordance with International Financial Reporting Standards (IFRS) promulgated by the International Accounting Standards Board. IFRS includes International Accounting Standards (IAS) and related interpretations. IFRS differs in certain material respects from accounting principles generally accepted in the United States of America (U.S. GAAP). See Note 31 to the Financial Statements for a description of the material differences between IFRS and U.S. GAAP as of December 31 of 2001 and 2002 and for each of the years in the three-year period ended December 31, 2002 as they relate to the Company.

Solely for the convenience of the readers, this Annual Report contains translations of certain Renminbi amounts into U.S. dollars at the rate of US$1.00 = RMB8.2773, which is the average of the buying and selling rates as quoted by the People s Bank of China at the close of business on December 31, 2002. No representation is made that the Renminbi amounts or U.S. dollar amounts included in this Annual Report could have been or could be converted into U.S. dollars or Renminbi, as the case may be, at any particular rate or at all. Any discrepancies in the tables included herein between the amounts listed and the totals are due to rounding.

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GLOSSARY OF AIRLINE INDUSTRY TERMS

In this Annual Report, unless the context indicates otherwise, the following terms shall have the respective meanings set forth below.

Capacity Measurements

available seat kilometers or ASKs	the number of seats made available for sale multiplied by the kilometers flown
available ton kilometers or ATKs	the number of tons of capacity available for the transportation of revenue load (passengers and cargo) multiplied by the kilometers flown

Traffic Measurements

revenue passenger kilometers or RPKs	the number of revenue passengers carried multiplied by the kilometers flown
cargo ton kilometers	the cargo load in tons multiplied by the kilometers flown
revenue ton kilometers or RTKs	the load (passenger and cargo) in tons multiplied by the kilometers flown

Yield Measurements

passenger yield	revenue from passenger operations divided by RPKs
cargo yield	revenue from cargo operations divided by cargo ton kilometers
average yield	revenue from airline operations (passenger and cargo) divided by RTKs
ton	a metric ton, equivalent to 2,204.6 pounds

Load Factors

passenger load factor	RPKs expressed as a percentage of ASKs
overall load factor	RTKs expressed as a percentage of ATKs
breakeven load factor	the load factor required to equate scheduled traffic revenue with operating costs assuming that total operating surplus is attributable to scheduled traffic operations

Utilization

utilization rate	the actual number of flight hours per aircraft per operating day

Equipment

rotables	aircraft parts that are ordinarily repaired and reused
expendables	aircraft parts that are ordinarily used up and replaced with new parts

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS.

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE.

Not applicable.

ITEM 3. KEY INFORMATION.

Selected Financial Data

The following selected consolidated income statement data for each of the years in the five-year period ended December 31, 2002 and consolidated balance sheet data for each of the years in the five-year period ended December 31, 2002 have been derived from the consolidated financial statements of the Company. Such consolidated financial statements have been audited by KPMG, independent certified public accountants, and prepared in accordance with IFRS on the basis that the Company with all its present divisions and subsidiaries had been so constituted during the relevant periods. IFRS differs in certain material respects from U.S. GAAP. See Note 31 to the Financial Statements for a description of the material differences related to the Group between IFRS and U.S. GAAP as of December 31, 2001 and 2002 and for each of the years in the three-year period ended December 31, 2002. The following information should be read in conjunction with, and is qualified in its entirety by, the Financial Statements of the Group.

	Year ended December 31,					
	1998	**1999**	**2000**	**2001**	**2002**	**2002**
	RMB	**RMB**	**RMB** (in million, except per share data)	**RMB**	**RMB**	**US$**
Income Statement Data:						
IFRS:						
Operating revenue	11,849.4	13,299.6	15,178.3	16,879.7	18,018.6	2,176.9
Operating expenses	11,259.4	11,449.7	13,996.2	15,479.0	15,992.5	1,932.1
Operating income	590.0	1,849.9	1,182.1	1,400.7	2,026.1	244.8
Equity (loss) income of affiliated companies	(1.8)	36.1	45.9	53.0	37.0	4.5
Equity loss of jointly controlled entities				(4.0)	(3.4)	(0.4)
Gain (loss) on sale of fixed assets	182.9	(18.7)	372.6	(55.9)	170.7	20.6
Interest expense	(1,197.4)	(1,192.2)	(1,074.2)	(933.7)	(959.2)	(115.9)
Exchange (loss) gain, net	(366.3)	(426.5)	318.5	296.8	(175.4)	(21.2)
Other, net	205.2	119.9	86.3	38.4	43.3	5.2
(Loss) income before taxation and minority interests	(587.4)	368.5	931.2	795.3	1,139.1	137.6
Taxation	178.6	(128.0)	(338.9)	(320.5)	(398.2)	(48.1)
Minority interests	(105.8)	(158.1)	(90.5)	(134.6)	(165.1)	(19.9)
Net (loss) income	(514.6)	82.4	501.8	340.2	575.8	69.6
Basic (loss) earnings per share	(0.15)	0.02	0.15	0.10	0.17	0.021
Basic (loss) earnings per ADS	(7.63)	1.22	7.44	5.04	8.53	1.03
U.S. GAAP:						
Net (loss) income	(582.2)	370.3	354.4	430.7	474.0	57.3

Basic (loss) earnings per share	(0.17)	0.11	0.11	0.13	0.14	0.017
Basic (loss) earnings per ADS	(8.63)	5.49	5.25	6.38	7.02	0.85

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	December 31,					
	1998	1999	2000	2001	2002	2002
	RMB	RMB	RMB	RMB	RMB	US$
	(in million)					
Balance Sheet Data:						
IFRS:						
Cash and cash equivalents	4,103.7	4,588.4	4,197.5	2,817.9	3,771.0	455.6
Other current assets	2,080.7	1,715.2	1,691.9	1,560.5	1,834.8	221.7
Fixed assets, net	22,904.3	24,211.2	23,282.1	22,352.2	26,920.8	3,252.4
Total assets	32,083.3	32,557.7	30,924.0	30,653.1	37,188.0	4,492.8
Notes payable, including current portion of long term notes payable	666.8	613.3	783.1	2,177.5	5,240.7	633.1
Current installments of obligations under capital leases	1,120.0	1,999.7	1,776.2	1,451.9	1,566.7	189.3
Notes payable, excluding current portion	5,032.6	4,424.2	3,788.7	3,627.6	5,835.4	705.0
Obligations under capital leases, excluding current installments	11,845.3	11,490.9	9,416.3	7,691.6	6,631.8	801.2
Shareholders equity	8,297.3	8,379.7	8,881.4	9,221.7	9,613.2	1,161.4
U.S. GAAP:						
Shareholders equity	7,857.1	8,227.4	8,527.3	8,958.0	9,287.3	1,122.0

Selected Operating Data

The following selected operating data of the Group for the five years ended December 31, 2002 have been derived from financial statements prepared in accordance with IFRS and other data provided by the Group and have not been audited. In accordance with Order No. 88 of the General Administration of Civil Aviation of China (also known as the Civil Aviation Administration of China) (the CAAC), titled Measures for the Administration of China s Civil Aviation Statistics, new statistical standards have been implemented with effect from January 1, 2001. The Group has not adjusted the operating data for the corresponding period in 1998 and 1999 according to the new standards. The main differences between the two sets of standards are set forth below:

1. The standard passenger weight has been changed from 75 kg per person to 90 kg per person (luggage weight included). Luggage weight will not be separately calculated;

2. Number of scheduled flights has been changed to number of takeoffs;

3. Any passenger carried on flights which fly international routes will be counted as one domestic passenger and one international passenger; however, any passenger carried on an irregular flight will only be counted once; any cargo carried on flights which fly international routes will be counted as one domestic and one international cargo; however, cargo carried on an irregular flight will only be counted once.

Apart from the data set out in the table below, the operating data and the profit analysis and comparison for the years 2001 and 2002 below is calculated and disclosed in accordance with the new statistical standards. See Glossary of Airline Industry Terms at the front of this Annual Report for definitions of certain terms used herein.

	Year ended December 31,				
	1998	1999	2000	2001	2002
Capacity					
ASK (million)					
Domestic	23,417	24,900	28,345	31,393	33,753
Hong Kong regional	1,673	1,791	1,744	1,690	1,746
International	5,060	5,155	5,742	6,981	8,746
Total	30,150	31,846	35,831	40,064	44,245
ATK (million)					

Domestic	2,709	2,865	3,322	3,622	3,924
Hong Kong regional	206	214	198	185	193
International	667	683	1,087	1,317	1,798

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	Year ended December 31,				
	1998	1999	2000	2001	2002
Total	3,582	3,762	4,607	5,124	5,915
Kilometers flown (thousand)	170,188	182,200	209,431	234,051	258,379
Hours flown (thousand)	239	287	326	365	405
Number of flights					
Domestic	121,902	126,120			
Hong Kong regional	12,477	13,460			
International	5,930	6,600			
Total	140,309	146,180			
Number of landing and take-offs					
Domestic			165,726	183,651	194,776
Hong Kong regional			14,255	13,712	13,891
International			8,861	10,698	13,990
Total			188,842	208,061	222,657
Traffic					
RPK (million)					
Domestic	14,637	14,511	16,974	19,447	22,092
Hong Kong regional	972	1,106	1,074	1,060	1,081
International	2,652	3,068	3,605	4,550	5,767
Total	18,261	18,685	21,653	25,057	28,940
RTK (million)					
Domestic	1,487	1,518	1,941	2,217	2,532
Hong Kong regional	92	106	107	105	108
International	336	379	565	712	974
Total	1,915	2,003	2,613	3,034	3,614
Passengers carried (thousand)					
Domestic	12,985	12,769	14,450	16,499	18,535
Hong Kong regional	1,287	1,434	1,444	1,409	1,369
International	780	909	957	1,213	1,589
Total	15,052	15,112	16,851	19,121	21,493
Cargo and mail carried (tons)	348,041	390,750	353,000	398,000	470,000
Load Factors					
Passenger load factor (RPK/ASK) (%)					
Domestic	62.5	58.3	59.9	61.9	65.5
Hong Kong regional	58.1	61.8	61.6	62.7	61.9
International	52.4	59.5	62.8	65.2	65.9
Total	60.6	58.7	60.4	62.5	65.4
Overall load factor (RTK/ATK) (%)					
Domestic	54.9	53.0	58.4	61.2	64.5
Hong Kong regional	44.9	49.5	54.0	56.8	55.8
International	50.4	55.5	52.0	54.1	54.2
Total	53.5	53.2	56.7	59.2	61.1
Breakeven load factor (%)	52.3	47.5	54.0	55.6	55.9
Yield					
Yield per RPK (RMB)					
Domestic	0.58	0.65	0.62	0.62	0.55
Hong Kong regional	1.14	1.00	1.06	1.06	0.98
International	0.40	0.42	0.43	0.41	0.42
Total	0.58	0.63	0.61	0.60	0.54
Yield per cargo and mail ton kilometers	1.72	1.63	2.13	1.76	1.73

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	Year ended December 31,				
	1998	1999	2000	2001	2002
Yield per RTK (RMB)					
Domestic	6.15	6.69	5.90	5.83	5.21
Hong Kong regional	12.59	11.00	11.19	11.26	10.36
International	3.71	3.96	3.63	3.31	3.25
Total	6.04	6.40	5.63	5.43	4.84
Fleet					
Boeing	81	81	89	91	102
Other	21	20	20	20	20
Total aircraft in service at period end	102	101	109	111	122
Overall utilization rate (hours per day)	7.7	8.1	8.7	9.1	9.8
Financial					
Operating cost per ASK (RMB)	0.37	0.36	0.39	0.39	0.36
Operating cost per ATK (RMB)	3.14	3.04	3.04	3.02	2.70

Exchange Rate Information

The following table sets forth certain information concerning exchange rates, based on the noon buying rates in New York City for cable transfers in foreign currencies, as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate), between Renminbi and U.S. dollars for the five most recent financial years.

Period	Period End	Average(1) (RMB per US$)	High	Low
Annual Exchange Rate				
1998	8.2789	8.2789	8.2802	8.2770
1999	8.2793	8.2793	8.2917	8.2669
2000	8.2781	8.2784	8.2799	8.2768
2001	8.2766	8.2766	8.2910	8.2642
2002	8.2773	8.2773	8.2897	8.2152

The following table sets out the range of high and low exchange rates, based on the Noon Buying Rate, between Renminbi and U.S. dollars, for the following periods.

Period	High	Low
Monthly Exchange Rate		
December 2002	8.2775	8.2770
January 2003	8.2772	8.2766
February 2003	8.2775	8.2768
March 2003	8.2775	8.2770
April 2003	8.2774	8.2769
May 2003	8.2771	8.2768

On June 20, 2003, the noon rate of exchange, as reported by the Federal Reserve Bank of New York, was RMB8.2770 per U.S. dollar.

(1) Determined by averaging the rates on the last business day of each month during the relevant period.

Dividend Payments

No interim dividend was paid during the year ended December 31, 2002. The Board of Directors of the Company does not recommend the payment of a final dividend in respect of the year ended December 31, 2002. A final dividend of RMB0.02 (before tax) per share totaling RMB67.5 million (before tax) in respect of financial year 2001 was paid to shareholders during the year.

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Capitalization and Indebtedness

Not applicable.

Reasons for the Offer and Use of Proceeds

Not applicable.

Risk Factors

Risks relating to the Company

Government ownership and control of the Company

All Chinese airlines are wholly- or majority-owned either by the Chinese Government or by provincial or municipal governments in China. CSAHC, an entity wholly-owned by the Chinese Government, holds and exercises the rights of ownership of all of the Domestic Shares or 65.2% of the equity of the Company. The interests of the Chinese Government in the Company and in other Chinese airlines may conflict with the interests of the holders of the ADSs and the H Shares. The public policy considerations of the Chinese Government in regulating the Chinese commercial aviation industry may also conflict with its indirect ownership interest in the Company.

High operating leverage and foreign exchange exposure

The airline industry is generally characterized by a high degree of operating leverage. In addition, due to high fixed costs, including payments made in connection with the Company s aircraft leases, the expenses relating to the operation of any flight do not vary proportionately with the number of passengers carried, while revenues generated from a flight are directly related to the number of passengers carried and the fare structure of such flight. Accordingly, a decrease in revenues could result in a proportionately higher decrease in net income. Moreover, because the Company has substantial obligations denominated in foreign currencies, its results of operations are significantly affected by fluctuations in foreign exchange rates, particularly for the US dollar and the Japanese Yen. The Company recognized a net exchange gain of RMB297 million for 2001 and incurred a net exchange loss of RMB175 million for 2002, as a result of yen fluctuations. A majority of these exchange gain/loss were unrealized in nature.

Potential conflicts of interest

CSAHC will continue to be the controlling shareholder of the Company and CSAHC and certain of its affiliated companies will continue to provide certain important services to the Company, including the import and export of aircraft spare parts and other flight equipment, housing services and pension and financial services. In addition, Mr. Yan Zhi Qing, the Chairman of the Board of Directors of the Company (Board of Directors), also serves as the President of CSAHC. The interests of CSAHC may conflict with those of the Company. In addition, any disruption of the provision of services by the affiliated companies or a default by CSAHC of its obligations owed to the Company could affect the Company s operations and financial condition. In particular, as part of its cash management system, the Company periodically places significant amount of demand deposits to Southern Airlines Group Finance Company Limited (SA Finance), a PRC authorized financial institution controlled by CSAHC and an affiliated company of the Group. As a result, the Company s deposits with SA Finance are subject to the risks associated with the business of SA Finance over which the Company does not exercise control. As of December 31, 2001 and 2002, the Group had short-term deposits of RMB1,341 million and RMB901 million, respectively, with SA Finance.

Certain transactions between the Company and CSAHC or its affiliates (as defined in the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the Hong Kong Listing Rules)) will constitute connected transactions of the Company under the Hong Kong Listing Rules and, unless exemptions are applicable or waivers are granted, will be subject to disclosure requirements and/or independent shareholders approval in a general meeting.

Management reporting practices

The Company s management and other employees have experience operating the Company s businesses since such businesses were conducted by CSAHC. However, by comparison to other long-established international airlines, the Company has fewer and less sophisticated financial, management and other reporting and planning practices.

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Risks relating to certain real property

Although systems for registration and transfer of land use rights and related real property interests in China have been implemented, such systems do not yet comprehensively account for all land and related property interests. The land in Guangzhou on which the Company s headquarters buildings and related aircraft maintenance and other facilities are located and the buildings that the Company uses at its route base in Wuhan, Haikou and Zhengzhou are leased by the Company from CSAHC. However, CSAHC lacks adequate documentation evidencing CSAHC s rights to such land and buildings, and, as a consequence, the lease agreements between CSAHC and the Company for such land have not been registered with the relevant authorities. As a result, such lease agreements may not be enforceable. There are certain other parcels of land and buildings owned or used by the Company and the subsidiaries that lack adequate documentation. Lack of adequate documentation for land use rights and ownership of buildings subjects the Company to challenges and claims by third parties with respect to the Company s use of such land and buildings, and impairs the ability of the Company to dispose of or mortgage such land use rights and buildings.

The Company has been occupying all of the land and buildings described above without challenge. CSAHC has received written assurance from the CAAC to the effect that CSAHC is entitled to continued use and occupancy of the land in Guangzhou and certain related buildings and facilities. However, such assurance does not constitute formal evidence of CSAHC s right to occupy such lands, buildings and facilities, or the right to transfer, mortgage or lease such real property interests. The Company cannot predict the magnitude of the adverse effect on its operations if its use of any one or more of these parcels of land or buildings were successfully challenged. CSAHC has agreed to indemnify the Company and Guangzhou Aircraft Maintenance Engineering Company Limited (GAMECO), the Company s affiliated company, against any loss or damage caused by any challenge of, or interference with, the use by the Company and GAMECO of any of their respective land and buildings.

Risks associated with Hong Kong regional routes

The Company s Hong Kong regional routes benefit from traffic originating in Taiwan. The Company s Hong Kong regional routes may be materially adversely affected if direct flights between Taiwan and Mainland China were permitted in the future. In such event, Xiamen Airlines Company Limited (Xiamen Airlines), the Company s subsidiary, may apply for route rights for direct flights between Taiwan and mainland China, due partly to the proximity to Taiwan of Fujian province, where Xiamen Airlines are based. However, there can be no assurance that sufficient routes and flights between destinations in Taiwan and mainland China could be obtained by Xiamen Airlines, if at all, or as to the yields on these routes and flights.

Risks Relating to the Chinese Commercial Aviation Industry

Impact of the Recent Outbreak of Severe Acute Respiratory Syndrome (SARS)

The outbreak of SARS in the PRC, Hong Kong, Singapore and Taiwan has brought about uncertainty to the global economy. In particular, the outbreak of SARS in the PRC affected the domestic demand and has an overdue impact on the overall economy of the PRC.

Based on the currently available information and certain historical figures of the Group,

(i) the average revenue passenger kilometers (RPK) of the Group in May 2003 decreased by 73.48% compared to April 2003, or by 83.50% compared to the same period last year; and

(ii) the total number of passengers of the Group in May 2003 decreased by 82.60% compared to the same period last year.

In response to the adverse change in operational environment of the Group brought about by the outbreak of SARS, the Group has implemented various continuing measures to adjust its operational capacity accordingly, which include negotiating with aircraft manufacturers to explore the possibility of postponing the delivery date of new aircraft and requesting its staff to take leave at a reduced salary on rotation. In addition, the Group has continued its efforts in fully implementing the precautionary measures in accordance with the general guidelines issued by the Hygiene Department of the Chinese Government, in order to tackle the potential spread of SARS on its airlines and at all contact points with its passenger.

Government regulation

The Company s ability to implement its business strategy will continue to be affected by regulations and policies issued or implemented by the CAAC, which encompass substantially all aspects of the Chinese commercial aviation industry, including the approval of domestic, Hong Kong regional and international route allocation, air fares, aircraft acquisition, jet fuel prices and standards for aircraft maintenance, airport operations and air traffic control. Such regulations and policies limit the flexibility of the Company to respond to market conditions, competition or changes in the Company s cost structure. The implementation of specific CAAC policies could from time to time adversely affect the Company s operations. The CAAC has confirmed in writing that the Company will be treated equally with other Chinese airlines with respect to certain matters regulated by the CAAC. Nevertheless, there can be no assurance that the CAAC will, in all circumstances, apply its regulations and policies in a manner that results in equal treatment of all airlines that are similarly situated.

Jet fuel supply and costs

The availability and cost of jet fuel have a significant impact on the Group s results of operations. The Group s jet fuel costs for 2002 accounted for 22.0% of its operating expenses. All of the domestic jet fuel requirements of Chinese airlines (other than at the Shenzhen, Zhuhai and Sanya airports) must be purchased from the exclusive providers, China Aviation Oil Supplies Company (the CAOSC) and Bluesky Oil Supplies Company, companies controlled and supervised by the CAAC. Chinese airlines may also purchase their jet fuel requirements at the Shenzhen, Zhuhai and Sanya airports from joint ventures in which the CAOSC is a partner. Jet fuel obtained from the CAOSC s regional branches is purchased at uniform prices throughout China that are determined and adjusted by the CAOSC from time to time with the approval of the CAAC and the pricing department of the State Planning Commission based on market conditions and other factors. As a result, the costs of transportation and storage of jet fuel in all regions of China are spread among all domestic airlines. Prior to 1994, domestic jet fuel prices were generally below international jet fuel prices. Since then, however, domestic jet fuel price from CAOSC has always been higher than international jet fuel prices, often creating tension in fuel supply. In addition, jet fuel shortages have occurred in China and, on limited occasions before 1993, required the Company to delay or cancel flights. Although such shortages have not materially affected the Company s results of operations since 1993, there can be no assurance that such shortage will not occur in the future. If such shortage occurs in the future and the Company is forced to delay or cancel flights due to fuel shortage, its operational reputation among passengers and results of operations may suffer.

Infrastructure limitations

The rapid increase in air traffic volume in China in recent years has put pressure on many components of the Chinese commercial aviation industry, including China s air traffic control system, the availability of qualified flight personnel and airport facilities. Airlines, such as the Company, which have route networks that emphasize short- to medium-haul routes are generally more affected by insufficient aviation infrastructure in terms of on-time performance and high operating costs due to fuel inefficiencies resulting from the relatively short segments flown, as well as the relatively high proportion of time on the ground during turnaround. All of these factors may adversely affect the perception of the service provided by an airline and, consequently, the airline s operating results. In recent years, the CAAC has placed increasing emphasis on the safety of Chinese airline operations and has implemented measures aimed at improving the safety record of the industry. The ability of the Company to increase utilization rates and to provide safe and efficient air transportation in the future will depend in part on factors such as the improvement of national air traffic control and navigation systems and ground control operations at Chinese airports, which factors are beyond the control of the Company.

Competition

The CAAC s extensive regulation of the Chinese commercial aviation industry has had the effect of managing competition among Chinese airlines. Nevertheless, competition has become increasingly intense in recent years due to a number of factors, including relaxation of certain regulations by the CAAC, and an increase in the capacity, routes and flights of Chinese airlines. Competition in the Chinese commercial aviation industry has led to widespread price-cutting practices that do not in all respects comply with applicable regulations. The CAAC has just begun to monitor these activities and has imposed fines on several airlines, including the Company and other major airlines. However, until the interpretation of these CAAC regulations has been finalized and strictly enforced, discounted tickets from competitors will continue to have an adverse effect on the Company s sales.

The Company faces varying degrees of competition on its Hong Kong regional routes from certain Chinese airlines and Dragon Air and on its international routes, primarily from non-Chinese airlines, most of which have significantly longer operating histories, substantially greater financial and technological resources and greater name recognition than the Company. In addition, the public s perception of the safety and service records of Chinese airlines could adversely affect the Company s ability to compete against its Hong Kong regional and international competitors. Many of the Company s international competitors have larger sales networks and participate in reservation systems that are more comprehensive and convenient than those of the Company, or engage in promotional activities, such as International Alliance programs, that may enhance their ability to attract international passengers.

Limitation on foreign ownership

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Chinese Government policies limit foreign ownership in Chinese airlines. Under these policies, the percentage ownership of the Company s total outstanding ordinary shares held by investors in Hong Kong and any country outside China (Foreign Investors) may not in the aggregate exceed 49%. Currently, 34.8% of the total outstanding ordinary shares of the Company is held by Foreign Investors. As a result of this limitation on foreign ownership, the Company will have no meaningful access to the international equity capital markets unless the restriction on foreign ownership of A Share is lifted. Currently A Shares are domestic shares listed or to be listed on a Chinese stock exchange.

Consolidation and Restructuring

In the second half of 2000, the CAAC announced a restructuring plan with respect to the PRC aviation industry. Pursuant to such restructuring plan, domestic airlines are directed to consolidate, on a voluntary basis, into three major airline groups in China: CSAHC, China National Aviation Holding Company (formerly, the Air China Group) and China Eastern Air Holding Group (formerly, the Eastern Air Group). After CSAHC informed the Company that CSAHC will participate in such restructuring plan, the Company announced that it will also participate in such consolidation and restructuring pursuant to the CAAC directives. The possible mergers of domestic airlines and other restructuring and consolidation activities pursuant to the CAAC restructuring plan may involve uncertainties and risks over a long period of time, including the following:

- failure to achieve the anticipated synergies, cost savings or revenue enhancing opportunities resulting from the restructuring activities;
- diversion of management s attention from existing business concerns and other business opportunities of the Group;
- difficulty in integrating the assets and business of other airlines, including its employees, corporate culture, managerial systems and processes, business information systems and services;
- difficulty in exercising control and supervision over various new operations within the Group;
- failure to retain key personnel; and
- increase in financial pressure due to assumption of recorded/unrecorded liabilities of the acquired businesses.

The inability to manage additional businesses or integrate successfully the acquired businesses without substantial expense, delay or other operational or financial problems, or the occurrence of one or more of the events enumerated above, could materially adversely affect the Group s financial condition and results of operations.

Risks relating to the PRC

Foreign exchange risks

Renminbi is not a freely convertible currency, and the Company s ability to obtain or retain foreign currencies is subject to regulation in China. Limitations on the availability of foreign exchange could have a material adverse effect on the Company s operations and financial condition, particularly in light of the Company s substantial foreign currency obligations.

The value of Renminbi is subject to changes in Chinese Government policies and depends to a large extent on China s domestic and international economic and political developments, as well as supply and demand in the local market. Since 1994, the official exchange rates for the conversion of Renminbi to US dollars have been stable. There can be no assurance, however, that such rates will not be volatile or that there will be no further devaluation of the Renminbi against the foreign currencies in which the Company s obligations are denominated, principally the US dollar and the Japanese Yen. Based on the Company s foreign currency denominated obligations as of December 31, 2002, a 1% change in the exchange rate between the Renminbi and the US dollar, or between the Renminbi and Japanese Yen, would have resulted in an unrealized gain or loss of RMB119 million (US$14 million). As the Company is not able to hedge effectively against the devaluation of the Renminbi other than by retaining its foreign exchange-denominated earnings and receipts to the extent permitted by applicable law, any future devaluation in the Renminbi could adversely affect the Company s results of operations and financial condition. The Company s results of operations and financial condition may also be affected by changes in the value of currencies other than the Renminbi in which the Company s earnings and obligations are denominated.

Developing legal system

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The Chinese legal system is based on written statutes and is a system, unlike common law systems, in which decided legal cases have little precedential value. In 1979, China began to promulgate a more comprehensive system of laws. On December 29, 1993, the Chinese National People s Congress promulgated the Company Law, which became effective on July 1, 1994. In August 1994, pursuant to the Company Law, the PRC State Council issued the PRC Special Regulations on Overseas Offering and Listing of Shares by Companies Limited by Shares to regulate joint stock companies that offer and list their shares overseas. These laws, regulations and legal requirements are relatively recent, and, like other laws, regulations and legal requirements applicable in China (including with respect to the commercial aviation industry), their interpretation and enforcement involve significant uncertainties.

Taxation of holders of H Shares or ADS by China

Chinese tax law generally provides for the imposition of a withholding tax on dividends paid by a Chinese company to a non-Chinese shareholder at a rate of 20%. In a notice issued by the State Taxation Bureau of the PRC and a letter issued by the State Taxation Bureau, however, the Chinese tax authorities confirmed that the imposition of this withholding tax on dividends paid by joint stock companies, such as the Company, had been suspended. Accordingly, any future dividends to be paid by the Company to holders of H Shares or ADS who are foreign individuals not resident in China or which are foreign enterprises with no permanent establishment in China will not be subject to a Chinese withholding tax. In the event that the suspension of the withholding tax is lifted, such payments will subject to withholding tax at the 20% rate unless the holder is entitled to a tax waiver or a lower tax rate under an applicable double-taxation treaty. See Item 10 Additional Information Taxation .

ITEM 4. INFORMATION ON THE COMPANY.

History and Development of the Company

The Company is a joint stock company incorporated in China on March 25, 1995, and is 65.2% owned by CSAHC. The registered address of the Company is Baiyun International Airport, Guangzhou 510405, People s Republic of China (telephone no: (86)20-8612-4738, website: www.cs-air.com).

In the second half of 2000, the CAAC announced a restructuring policy with respect to the PRC aviation industry. Domestic airlines are directed, on a voluntary basis to consolidate into three major airline groups: CSAHC, China National Aviation Holding Company and China Eastern Air Holding Group . In line with such policy, CSAHC has acquired Zhongyuan Airlines, a regional airline based in Henan Province, the PRC in 2001.

In April 2001, SA Group informed the Company that SA Group would participate in the restructuring of the PRC aviation industry under PRC government directives. Although such directives are general guidelines relating to consolidation and restructuring of PRC aviation industry, it is highly unlikely that Chinese airlines will not follow all or most of such proposals. SA Group informed the Company that SA Group would conduct negotiations with China Northern Airlines and Xinjiang Airlines with respect to possible cooperation involving consolidation and restructuring with those airlines.

On October 11, 2002, SA Group, China Northern Airlines and Xinjiang Airlines restructured and consolidated into a new airline group named as China Southern Air Group after a long period of preparation. On the same date, SA Group changed its official name to China Southern Air Holding Company (CSAHC).

The Group had RMB1,381 million, RMB1,492 million and RMB6,351 in capital expenditures in 2000, 2001 and 2002 respectively. Of such capital expenditures in 2002, RMB3,832 million were financed by bank borrowings while the remaining RMB2,519 million were financed by internal resources. The capital expenditures were primarily incurred on the additional investments in aircraft and flight equipment under the Group s fleet expansion plans and Guangzhou new airport, and, to a small extent, additional investments in pilot training facilities and other facilities and building for operations.

Shareholders resolutions of the Company were passed at the second Extraordinary General Meeting of the Company in the year 2002 held on March 26, 2002 approving the issue of domestic ordinary share(s) of the Company of RMB 1.00 each. The number of A Shares proposed to be issued is not more than 1,000,000,000 A Shares. Other details of the A Shares Issue were previously published by way of announcement dated March 26, 2002. The proposed A Share Issue is subject to approval by the China Securities Regulatory Commission and Shanghai Stock Exchange of the listing and trading in the A Shares on the Shanghai Stock Exchange.

The Company has on June 18, 2002 entered into an Interest Transfer and Capital Injection Agreement with China State Post Bureau, Shanghai Municipal Post Office, Post Office of the Inner Mongolian Autonomous Region and China Philately Corporation, pursuant to which the

Company has injected RMB150 million (equivalent to approximately US$18.12 million) in cash to acquire 49% interest in China Postal Airlines, Ltd. The China State Post Bureau holds the remaining 51%.

In addition, during the year, the Group acquired 39% interest in Sichuan Airlines Corporation Limited to further expand its market shares in South-western China. The Group also jointly established Zhuhai Xiang Yi Aviation Technology Company Limited, the first sino-foreign joint venture company engaging in aviation training services in the PRC, with CAE.

Business Overview

General

The Group provides commercial airline services throughout China, Hong Kong and Macau regions, Southeast Asia and other parts of the world. The Group is one of the three largest Chinese airlines and, as of year end 2002, ranked first in terms of passengers carried, number of scheduled flights per week, number of hours flown and size of route network and aircraft fleet. During the three years ended December 31, 2002, the Group s RPKs increased at a compound annual rate of 15.6%, from 21,653 million in 2000 to 28,940 million in 2002, while its capacity, measured in terms of ASKs, increased at a compound annual rate of 11.1%, from 35,831 million in 2000 to 44,245 million in 2002. In 2002, the Group carried 21.49 million passengers and had passenger revenue of RMB15,696 million (US$1,896 million). Net income for 2002 was RMB576 million (US$70 million).

The Group conducts a portion of its airline operations through Xiamen Airlines, Southern Airlines (Group) Shantou Airlines Company Limited (Shantou Airlines), Guangxi Airlines Company Limited (Guangxi Airlines), Zhuhai Airlines Company Limited (Zhuhai Airlines) and Guizhou Airlines Company Limited (Guizhou Airlines) (collectively, the Airline Subsidiaries). In 2002, the Airline Subsidiaries carried 7.41 million passengers and had operating revenue of RMB4,829 million (US$583 million) and accounted for 34.5% and 26.8% of the Group s passengers carried and operating revenue, respectively.

The Group also provides air cargo and mail services. The Group s airline operations are fully integrated with its airline-related businesses, including aircraft maintenance and air catering operations. The cargo and mail revenue of the Group increased by 27.0% to RMB1,786 million (US$216 million) in 2002 as compared with 2001.

The Group operates the most extensive route network among Chinese airlines with a total of 349 routes as of December 31, 2002, including 286 domestic routes, 20 Hong Kong regional routes (which include Hong Kong routes and Macau routes), and 43 international routes. In 2002, the Group operated an average of 4,282 landing and take-offs per week serving 88 destinations, including 64 cities in China, including Beijing, Shanghai, Tianjin, Guangzhou, Shenzhen, Wuhan, Changsha, Zhengzhou, Xiamen, Xian and Chengdu. Most of the cities served by the Group are located in commercial centers or rapidly developing economic regions in China.

The Group s corporate headquarters and principal base of operations are located in Guangzhou, which is the capital of Guangdong Province and the largest city in southern China. Located in the rapidly developing Pearl River Delta region, Guangzhou is also the transportation hub of southern China and one of China s major gateway cities. Guangzhou s significance has increased as the transportation infrastructure of Guangdong Province has developed through the construction and development of expressways, an extensive rail network and the port cities of Yantian, Shekou, Chiwan, Mawan, Huangpu and Zhuhai.

In addition to its main route base in Guangzhou, the Group also maintains ten regional route bases in Zhengzhou, Wuhan, Changsha, Shenzhen, Zhuhai, Xiamen, Haikou, Guilin, Shantou and Guiyang. All of these regional route bases are located in provincial capitals or major commercial centers in China.

The Group s operations primarily focus on the domestic market. In addition, the Group also operates Hong Kong regional and international flights. As of year end of 2002, the Group had 20 Hong Kong regional routes and 43 international routes. The Group s Hong Kong regional operations include flights between destinations in China and Hong Kong and Macau. The Group s international operations include scheduled services to Osaka, Amsterdam, Sharjah, Los Angeles, Fukuoka, Seoul, Sydney and ten Southeast Asian destinations. The Group operates the most extensive Southeast Asian route network among Chinese airlines.

As of year end 2002, the Group operated a fleet of 122 aircraft, consisting primarily of Boeing 737-200, 737-300, 737-500, 737-700, 737-800, 747-200, 747-400, 757-200 and 777-200 aircraft and Airbus 320-200 aircraft. A significant portion of these aircraft are held under capital and operating leases. The average age of the Group s aircraft was 7.76 years at year end 2002.

Restructuring and Initial Public Offering

As part of China s economic reforms in the 1980 s, the PRC State Council directed the CAAC to separate its governmental, administrative and regulatory role from the commercial airline operations that were being conducted by the CAAC and its regional administrators. As a result, CSAHC was established on January 26, 1991 for the purpose of assuming the airline and airline-related commercial operations of the Guangzhou Civil Aviation Administration, one of the six regional bureaus of the CAAC. CSAHC was one of the 55 large-scale enterprises designated by the Chinese Government to play a leading role in their respective industries.

CSAHC was restructured in 1994 and 1995 in anticipation of the initial public offering of the Company. The restructuring was effected through the establishment of the Company and the execution of the Demerger Agreement, dated as of March 25, 1995, as amended (the Demerger Agreement), between CSAHC and the Company. Upon the restructuring, the Company assumed substantially all of the airline and airline-related businesses, assets and liabilities of CSAHC, and CSAHC retained its non-airline and non-airline-related businesses, assets and liabilities, and the non-business assets and liabilities. Upon this separation, all interests, rights, duties and obligations of CSAHC, whenever created or accrued, were divided between the Company and CSAHC based on the businesses, assets and liabilities assumed by each of them under the Demerger Agreement. Under the Demerger Agreement, CSAHC agreed not to conduct or participate or hold any interest in, either directly or indirectly, any business, activity or entity in or outside China that competes or is likely to compete with the commercial interests of the Group, although CSAHC may continue to hold and control the affiliates of CSAHC existing on the date of the Demerger Agreement and may continue to operate the businesses of such affiliates.

In July 1997, the Company completed a private placement of 32,200,000 H Shares to certain limited partnership investment funds affiliated with Goldman Sachs & Co. and an initial public offering of 1,141,978,000 H Shares, par value RMB 1.00 per share, and listing of the H Shares on the Stock Exchange of Hong Kong Limited (the Hong Kong Stock Exchange) and American Depositary Shares (ADSs , each ADS representing 50 H Shares) on the New York Stock Exchange. Prior to the private placement and the initial public offering, all of the issued and outstanding shares of capital stock of the Company, consisting of 2,200,000,000 Domestic Shares, par value RMB 1.00 per share, were owned by CSAHC, which owns and exercises, on behalf of the Chinese Government and under the supervision of the CAAC, the rights of ownership of the Domestic Shares held by CSAHC. After giving effect to the private placement and the initial public offering, CSAHC continues to own the 2,200,000,000 Domestic Shares, representing approximately 65.2% of the total share capital of the Company, and will be entitled to elect all the directors of the Company and to control the management and policies of the Group. The remaining 34.8% of the share capital of the Company is owned by holders of H Shares. Domestic Shares and H Shares are both ordinary shares of the Company.

The Company has applied to the relevant PRC authorities for the issue of not more than 1,000,000,000 A Shares and the listing of such A Shares on the Shanghai Stock Exchange (the A Shares Issue Plan). The A Shares Issue Plan was approved by the Independent shareholders at the Extraordinary General Meetings held on March 26, 2002 and May 21, 2002, and the Board was authorised to plan for and on behalf of the Company deal with all relevant matters relating to the A Shares Issue.

Traffic

The following table sets forth certain statistical information with respect to the Group s passenger and cargo and mail traffic for the years indicated.

	Passengers Carried		Cargo and Mail Carried (tons)		Total Traffic (ton kilometers)	
Year	**Total**	**Increase (decrease) over previous year**	**Total**	**Increase over previous year**	**Total**	**Increase over previous year**
	(in million)	**(%)**	**(in thousand)**	**(%)**	**(in million)**	**(%)**
1998	15.05	(1.3)	348.0	11.6	1,915.0	6.7
1999	15.11	0.4	390.8	12.3	2,003.0	4.6
2000	16.85	11.5	353.0	9.7	2,613.0	30.5
2001	19.12	13.5	398.0	12.7	3,034.0	16.1
2002	21.49	12.4	470.0	18.1	3,614.0	19.1

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Route Network

Overview

The Group operates the most extensive route network among Chinese airlines. As of year end 2002, the Group operated 349 routes consisting of 286 domestic routes, 20 Hong Kong regional routes and 43 international routes. At such date, the Group s route network served 64 destinations within China and 24 destinations outside of China.

The Group continually evaluates its network of domestic, Hong Kong regional and international routes in light of its operating profitability and efficiency. The Group seeks to coordinate flight schedules with the Airline Subsidiaries on shared routes to maximize load factors and utilization rates. The acquisition of domestic, Hong Kong regional and international routes is subject to approval of the CAAC, and the acquisition of Hong Kong regional and international routes is also subject to the existence and the terms of agreements between the Chinese Government and the government of the Hong Kong SAR, the government of Macau Special Administrative Region of the People s Republic of China (Macau SAR) and the government of the proposed foreign destination.

In April 1997, the Company and Delta Airlines, one of the largest U.S. airlines, entered into an agreement for the provision of code sharing in respect of the Group s Guangzhou-Los Angeles route (the Code Sharing Agreement). The Code Sharing Agreement was approved by the CAAC and became effective in March 1999. Under the Code Sharing Agreement, Delta Airlines is permitted to sell tickets for the Los Angeles-Guangzhou route to passengers from various sales outlets in the United States using its DL code. Passengers use Delta Airlines within the United States for travel to Los Angeles, and the Group for travel from Los Angeles to Guangzhou. Similarly, the Group is permitted to sell tickets for travel between Guangzhou and 13 destinations in the United States using its CZ code. Under this arrangement, passengers use the Group for the Guangzhou-Los Angeles segment of the route and Delta Airlines between Los Angeles and one of the specified U.S. destinations. The Code Sharing Agreement increases the number of sales outlets within the United States for the Group s Los Angeles-Guangzhou route and allows the Group to provide coordinated reservation, confirmation and baggage check-in services from Guangzhou to destinations in the United States.

The Group has also entered into code-sharing agreements with several airlines such as Asiana Airlines, Japan Air System, Vietnam Airlines, Royal Dutch Airlines and Garuda Indonesian. Such operating measures expand the Group s route network.

Route Bases

The Group s main route base is in Guangzhou. The Group maintains ten regional route bases in Zhengzhou, Wuhan, Changsha, Shenzhen, Zhuhai, Xiamen, Haikou, Guilin, Shantou and Guiyang. All of these regional route bases are located in provincial capitals or major commercial centers in China. The Group s network of route bases provides the Group with routes covering all of China, except for Inner Mongolia, Tibet and Ningxia.

The Group believes that its extensive network of route bases enables it to coordinate flights and deploy its aircraft more effectively and to provide more convenient connecting flight schedules and access service and maintenance facilities for its aircraft. The Group believes that the number and location of these route bases may enhance the Group s ability to obtain the CAAC s approval of requests by the Group to open new routes and provide additional flights between these bases and other destinations in China. Under current regulations of the CAAC, airlines are generally expected to operate mainly from their route bases.

The Chinese Government has approved a new Guangzhou airport project, which commenced construction in 2000, with completion targeted for late 2003. Upon completion, the new airport will replace the Baiyun International Airport as the main hub of the Group s route network. With the approval of the Chinese Government, the Group began construction of its facilities at the new Guangzhou airport in 2000. The Group s total investment will be RMB3,540 million, of which RMB2,620 million will be financed by bank loans. Several major banks in the PRC have committed to finance the project. The balance of RMB920 million will be financed by internal resources. As of December 31, 2002, the Group invested a total of RMB432.6 million for this new airport project. The Group believes that the completion of the new airport will substantially enhance the Group s operations in the Southern China region.

Domestic Routes

The Group s domestic route network serves substantially all provinces and autonomous regions in China, including Guangdong, Fujian, Hubei, Hunan, Hainan, Guangxi, Jiangsu, Zhejiang, Henan and Anhui, and serves all four centrally-administered municipalities in China, namely, Beijing, Shanghai, Tianjin, and Chongqing. In 2002, the Group s most profitable domestic routes were the routes between Guangzhou and Beijing, Guangzhou and Shanghai, Shenzhen and Shanghai, Shenzhen and Beijing, Beijing and Guangzhou, Shanghai and Guangzhou, Beijing and Shenzhen, Shanghai and Shenzhen, Guangzhou and Hangzhou; and between Guangzhou, Dalian and Harbin.

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Hong Kong Regional Routes

The Group offers scheduled service between Hong Kong and Guangzhou, Kunming, Xiamen, Shantou and Beijing. The Group s Hong Kong regional routes also include routes between Hong Kong or Macau and other destinations in China, including Guilin, Zhengzhou, Changsha, Haikou,Luoyang, Sanya, Zhang Jia Jie and Guiyang, which the Group operates on a charter flight basis, as explained below. The Group believes that the routes on which it operates these charter flights are among its highest yielding routes, primarily because the Group faces limited competition on such routes and is consequently less subject to downward pricing pressures. In 2002, the most profitable Hong Kong regional routes were those between Guangzhou and Hong Kong, Hong Kong and Wuhan, Hong Kong and Guangzhou, Wuhan and Hong Kong, Hong Kong and Beijing, Hong Kong and Xiamen, Kunming and Hong Kong, Hong Kong and Kunming, Xiamen and Hong Kong; and between Beijing and Hong Kong.

The Group s charter flights are essentially regularly scheduled flights, but in theory permission to operate these charter flights is subject to monthly review by the CAAC and the Civil Aviation Department of the Hong Kong SAR. The CAAC has informally indicated that it primarily considers market demand and airline capability in granting permission for such flights. The Group has been able to maintain all of its Hong Kong regional routes on which it operates on a charter flight basis and believes that demand on such routes will continue. In 2002, the Group operated a total of more than 13,500 flights on its Hong Kong regional routes, accounting for approximately 31.2% of all passengers carried by Chinese airlines on routes between Hong Kong or Macau and destinations in China.

International Routes

The Group is the principal Chinese airline connecting the rapidly developing Pearl River Delta region of China to Southeast Asia, with 26 routes serving ten Southeast Asian destinations, including Singapore and major cities in Indonesia, Thailand, Malaysia, Philippines, Vietnam and Laos. In 2002, the Group s most profitable Southeast Asian routes were those between Manila, Xiamen and Beijing, Beijing, Xiamen and Manila, Singapore and Guangzhou; and between Guangzhou and Singapore . The Group believes that, among Chinese airlines, it is well-positioned to benefit from the business opportunities arising out of increased air traffic and the growing economic relationships between China and Southeast Asian countries.

In addition to the 26 routes serving ten Southeast Asian destinations, the Group also operates seventeen other international routes providing scheduled service to Amsterdam, Sharjah, Osaka, Tokyo, Fukuoka, Seoul, Los Angeles, Sydney and Melbourne. In April 2002, an international route between Guangzhou and Tokyo was launched.

Aircraft Fleet

The Group s fleet plan in recent years has emphasized expansion and modernization through the acquisition of new aircraft and the retirement of less efficient older aircraft. As of year end 2002, the Group operated a fleet of 122 aircraft with an average age of 7.76 years. All aircraft of the Group are Boeing and Airbus aircraft. The Group has the largest fleet among Chinese airline companies. Most of the aircraft operated by the Group are leased pursuant to various types of leasing arrangements.

The following table sets forth certain information regarding the Group s fleet of 122 aircraft as of December 31, 2002.

Model	Number of Aircraft	Average Age (years)	Average Passenger Capacity
Boeing 777-200	4	6.53	380
Boeing 777-21B1GW	5	5.28	292
Boeing 757-200	26	10.48	200
Boeing 737-800	5	0.22	167
Boeing 747F	4	7.01	n/a
Boeing 737-700	7	3.14	138
Boeing 737-500	18	10.15	132
Boeing 737-300	31	8.96	145
Boeing 737-200	2	15.77	128
Airbus 320-200	20	4.69	158

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During 2002, the Group continued to expand and modernize its aircraft fleet. In 2002, the Group s major aircraft transactions included:

(i) the cash purchase of one Boeing 757-200 aircraft and two Boeing 737-800 aircraft;

(ii) the acquisitions of two Boeing 747-400 freighters and three Boeing 737-800 aircraft financed by long term bank loans;

(iii) the acquisitions of five Boeing 737-300 aircraft from Zhongyuan Airlines, a subsidiary of CSAHC;

(iv) the addition of one Boeing 737-700 aircraft under operating lease;

(v) the extension of the operating leases of three Boeing 777-200 under operating leases for another five years;and

(vi) the sale and operating leaseback of four Boeing 757-200 aircraft.

Very Substantial Acquisition

On October 3, 2001 the Company entered into an agreement with the Boeing Company for acquiring twenty Boeing 737-800 aircraft and two Boeing 747-400 freighters during the period between 2002 and 2005 (the Transactions). The aggregate consideration in the Transactions exceeds 100% of the net tangible assets of the Company as published in its annual report dated December 31, 2000 and constitutes very substantial transactions under the Hong Kong Listing Rules. The PRC government and CSAHC, the 65.2% controlling shareholder of the Company, have approved the Transactions. CSAHC does not have any interest in the Transactions other than as a shareholder of the Company.

The twenty Boeing 737-800 aircraft acquired pursuant to the Transactions will replace twenty existing Boeing 737 series aircraft that the Company currently operates under operating leases. The Board considered that the Transactions are in the best interest of the Company and its shareholders as a whole.

Waiver from the Stock Exchange of Hong Kong Limited

A. In March 2002, the Hong Kong Stock Exchange granted a waiver to allow the Company to use a new size test based on ATKs to replace the normal net asset test and consideration test under Chapter 14 of the Listing Rules in respect of acquisition and disposal of aircraft.

The Hong Kong Stock Exchange has granted the waiver on and subject to the following conditions:

1. Instead of the normal tests under Chapter 14 of the Listing Rules, the tests may be calculated by reference to the ATKs for aircraft being acquired or disposed of as compared to the Company s aggregate fleet ATKs.

2. The proposed method of calculation for the four tests will replace the net asset test and the consideration test only, while the other two tests, namely, net profit and equity capital issued tests will continue to apply as set out in Chapter 14 of the Listing Rules.

3. The calculation of ATKs will be as follows: i) fleet ATKs will be the aggregate actual ATKs for all aircraft in the Company s fleet for the last financial year as disclosed in the Company s annual report, ii) ATKs for aircraft being disposed of will be based on actual ATKs of the aircraft for the previous two financial years; and iii) ATKs for aircraft being acquired will be based on the historical operating data for the same type of aircraft. Where the aircraft to be acquired is a new type, the ATKs will be estimated based on other aircraft of similar size operated by the Company or the average for the Chinese civil aviation industry.

4. The Company s ATKs figure will be disclosed in the Company s annual report and be reviewed by auditors who will confirm on an annual basis that the Company s ATKs are calculated correctly and consistently.

5. For the purposes of making the test as stated in paragraph 1 above, all acquisitions and disposals for the last 12 months will be aggregated, unless the acquisition or disposal has previously been reported as a notifiable transaction under these rules.

6. The thresholds for classifying a transaction as a discloseable, major or very substantial acquisition will be 30%, 50% and 100% (assuming that there are no circumstances which would make it a connected transaction or a share transaction).

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7. Where the transaction is a discloseable transaction, disclosure will take the form of a press announcement complying with rule 14.14 of the Listing Rules and details of the transaction will be set out in the Company s next annual report and accounts. Where the transaction is a major transaction or a very substantial acquisition, the provisions of Chapter 14 of the Listing Rules will apply.

8. An option to acquire aircraft will not be treated as acquisition while the exercise of such an option will be treated as the acquisition of an aircraft.

9. The waiver will only apply to acquisition/disposal of aircraft, and acquisition or disposal of other types of assets by the Company will be subject to provisions under Chapter 14 of the Listing Rules.

10. The Company will disclose in its annual reports and interim reports the following information:

    (i) regarding future deliveries of aircraft, details of aircraft on order including the number and type; and the years in which such aircraft are scheduled to be delivered;

    (ii) the number and type of aircraft which are subject to options exercisable during a period of not less than 12 months from the end of the financial year or period to which the annual report relates; and

    (iii) details of the waiver granted pursuant to the application.

11. The Company remains a subsidiary of CSAHC. Should there be any change in control of the Company, the Hong Kong Stock Exchange will need to reconsider whether the waiver continues to be appropriate.

B. In November 2002, the Hong Kong Stock Exchange granted a waiver in relation to the in-flight meals and ticket sales arrangements between the Group and CSAHC after approval of the consolidation and restructuring proposal of the PRC aviation industry by the State Council of the PRC (the Ongoing Connected Transactions for In-Flight meals and Ticket Sales).

The Hong Kong Stock Exchange has granted the waiver on and subject to the following conditions:

1. the Ongoing Connected Transactions for In-flight Meals and Ticket Sales shall be:

   (a) entered into in the ordinary and usual course of business of the Group;

   (b) conducted either on normal commercial terms or on terms no less favourable than terms available to (or from, as appropriate) independent third parties; and

   (c) on terms that are fair and reasonable so far as the shareholders of the Company and in the interest of the Company as a whole are concerned;

2. the aggregate annual amount payable by the Group to CSAHC, and the aggregate annual amount payable by CSAHC to the Group, under the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales for each financial year will not exceed the higher of HK$10 million and 3% of the consolidated net tangible assets of the company as disclosed in its latest published audited accounts (the Relevant Cap Amount);

3. the details of the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales will be disclosed in the company s annual report as set out in Rule 14.25(1)(A) to (D) of the Listing Rules for the relevant financial year of the Company;

4. the independent non-executive directors will review annually and confirm in the Company s annual report of the relevant financial year that the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales have been conducted in the manner as stated in paragraph 1 above and comply with the Relevant Cap Amount as stated in paragraph 2 above;

5. the auditors of the Company shall review annually the transactions and provide a letter to the Board of Directors stating that:

   (a) the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales have received approval of the Board of Directors of the Company;

   (b) the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales have been entered into in accordance with the terms of the agreements relating to the transactions;

   (c) the aggregate annual amount payable by the Group to CSAHC, and the aggregate annual amount payable by CSAHC to the Group, under the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales for each financial year shall not exceed the Relevant Cap Amount set out in paragraph 2 above; and

   (d) the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales are in accordance with the pricing policy of the Group.

   Where, for whatever reasons, the auditors decline to accept the engagement or are unable to provide the auditors letter, the Directors shall contact the Hong Kong Stock Exchange immediately.

6. CSAHC shall provide to the Hong Kong Exchange an undertaking that, for so long as the Company s shares are listed on the Hong Kong Stock Exchange, it will provide the Company s auditors with full access to its relevant records for the purpose of the auditors review of the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales.

Aircraft Financing Arrangements

Overview

A significant portion of the Group s aircraft is operated under long-term capital or operating leases or long-term mortgage loans with remaining terms to maturity ranging from one to nine years. As of December 31, 2002, 36 of the Group s 122 Boeing and Airbus aircraft were

operated under capital leases, 49 were operated under operating leases, 17 were financed by long-term mortgage loans, while the remaining were acquired either with cash proceeds or acquired by exercising the purchase options upon expiry of the respective capital leases. The Group s planned acquisitions of aircraft in the foreseeable future will generally be made pursuant to operating or capital leases. The Group s determination as to its acquisition strategy depends on the Group s evaluation at the time of its capacity requirements, anticipated deliveries of aircraft, the Group s capital structure and cash flow, prevailing interest rates and other general market conditions.

The following table sets forth, as of December 31, 2002, the number of Boeing and Airbus aircraft operated by the Group pursuant to capital and operating leases and the remaining terms, expressed in years, of such leases.

Model	Capital Lease	Operating Lease	Average Remaining Lease Term
Boeing 777-200 and 777-21B	6	3	7.69
Boeing 757-200	3	11	5.17
Boeing 737-500		18	2.80
Boeing 737-300	9	12	2.16
Airbus 320-200	18	2	6.44
Boeing 737-700		1	6.67
	36	49	

Capital Leases

As of December 31, 2002, the Group s aggregate future minimum lease payments (including future finance charges) required under its capital leases were RMB 9,745 million (US$1,177 million). As of year end 2002, a majority of the Group s capital leases had original terms ranging from ten to 15 years from the date of delivery of the relevant aircraft, and the remaining terms of these leases ranged from one to eight years. The Group s capital leases typically cover a substantial portion of the relevant aircraft s useful life and transfer the benefits and risks of ownership to the Group. Under its capital leases, the Group generally has an option to purchase the aircraft at or near the end of the lease term. As is customary in the case of capital leases, the Group s obligations are secured by the related aircraft, as well as other collateral.

Operating Leases

As of December 31, 2002, the Group s aggregate future minimum lease payments required under its operating leases were RMB8,537 million (US$1,031 million). As of year end 2002, the Group s operating leases had original terms generally ranging from within one year to ten years from the date of delivery of the relevant aircraft, and the remaining terms of these leases generally ranged from one to eight years. Pursuant to the terms of the operating leases, the Group is obligated to make rental payments based on the lease term, with no termination payment obligations or purchase option, and the lessor bears the economic benefits and risks of ownership. Under its operating leases, the Group has no option to purchase the aircraft and is required to return the aircraft in the agreed condition at the end of the lease term. Although title to the aircraft remains with the lessor, the Group is responsible during the lease term for the maintenance, servicing, insurance, repair and overhaul of the aircraft.

Aircraft Flight Equipment

The jet engines used in the Group s aircraft fleet are manufactured by General Electric Corporation, Rolls-Royce plc, United Technologies International, Inc., CFM International, Inc. and International Aviation Engines Corporation. As of year end 2002, the Group had 34 spare jet engines for its fleet. The Group determines its requirements for jet engines based on all relevant considerations, including manufacturers recommendations, the performance history of the jet engines and the planned utilization of its aircraft.

Rotables and certain of the expendables for the Group s aircraft are generally purchased by Southern Airlines (Group) Import & Export Trading Corporation (SAIETC), a subsidiary of CSAHC acting as agent for the Group, in consideration of an agency fee. The Group arranges the ordering of aircraft, jet engines and other flight equipment for the Airline Subsidiaries and keeps an inventory of rotables and expendables for the Airline Subsidiaries.

Aircraft Maintenance

A major part of the maintenance for the Group s fleet other than overhauls of jet engines is performed by GAMECO, a joint venture established by the Company, Lockheed Martin (Lockheed) and Hutchison Whampoa (Hutchison) consistent with the Group s strategy to achieve fully integrated airline operations and to assure continued access to a stable source of high quality maintenance services. The remaining part of the maintenance for the Group s fleet other than overhauls of jet engines is performed by service providers in China and overseas. GAMECO performs all types of maintenance services, ranging from maintenance inspections performed on aircraft before, after and between flights (line maintenance services) to major overhaul performed at specified intervals. GAMECO was the first of three aircraft maintenance facilities in China having been certified as a repair station by both the CAAC and the FAA. In March 1998, GAMECO received an approval certificate from the United Kingdom Civil Aviation Authority for the repair and maintenance of aircraft and aircraft engines.

The Group believes that GAMECO performs major maintenance checks on the Group s aircraft within time periods generally consistent with those of large international airline maintenance centers. GAMECO s repair and maintenance capabilities include overhaul of more than 90% of the Group s aircraft. Although rotables for the Group s aircraft are generally imported through SAIETC, a portion of expendables and other maintenance materials are directly imported by GAMECO. GAMECO also provides line maintenance services to 18 other Chinese airlines and nine international airlines. GAMECO provides heavy maintenance services to fourteen other Chinese airlines and two international airline.

Under the Aircraft Maintenance and Engineering Agreement entered into between GAMECO and the Company (the Aircraft Maintenance Agreement), GAMECO charges the Group for expendables on a cost plus basis, and for labor based on a formula that takes into account projected flight hours, costs and other relevant factors. Fees under the Aircraft Maintenance Agreement are payable 50% in Renminbi and 50% in U.S. dollars. Each year, the Company and GAMECO determine the components of the pricing formula. For the year ended December 31, 2002, GAMECO s revenue totaled RMB592 million, approximately 95% of which was derived from services provided to the Group.

Overhauls of jet engines are performed by overseas qualified service providers in Germany, Malaysia, Canada and England.

Safety

The Group endeavors to maintain strict compliance with all laws and regulations applicable to flight safety. In addition, the Group has adopted measures to eliminate or minimize factors that may impair flight safety, including specialized training programs and safety manuals. The Air Safety Management Department of the Company implements safety-related training programs on an ongoing basis in all of the Group s operations to raise the safety awareness of all employees. As a result, overall flight safety has gradually improved. There was no serious incidents involving casualty or flight damage throughout the three years ended December 31, 2002. And for minor incidents which include various events and conditions prescribed by the CAAC which do not involve serious personal injury or material damage to flight equipment, the Group has kept the number consistently below the standard prescribed by the CAAC. For example, the Company s flight incident ratio was 0.15, 0.19 and 0.42 in 2000, 2001 and 2002 respectively. In comparison, CAAC s published maximum acceptable flight incident ratio was 1.6 in 2000, 2001 and 1.3 in 2002. This ratio is defined as the occurrence of one incident for every 10,000 hours of flight time.

Jet Fuel

Jet fuel costs typically represent a major component of an airline s operating expenses. The Group s jet fuel costs for 2002 accounted for 22.0% of the Group s operating expenses. Like all Chinese airlines, the Group is generally required by the Chinese Government to purchase its jet fuel requirements from regional branches of CAOSC and Bluesky Oil Supplies Company, except at the Shenzhen, Zhuhai and Sanya airports which are supplied by Sino-foreign joint ventures in which CAOSC is a joint venture partner. CAOSC is a State-owned organization controlled and supervised by the CAAC that controls the importation and distribution of jet fuel throughout China.

Jet fuel obtained from CAOSC s regional branches is purchased at uniform prices throughout China that are determined and adjusted by CAOSC from time to time with the approval of the CAAC and the pricing department of the State Development and Planning Commission (SDPC) based on market conditions and other factors. As a result, the costs of transportation and storage of jet fuel in all regions of China are spread among all domestic airlines. Jet fuel costs in China are influenced by costs at State-owned oil refineries and limitations in the transportation infrastructure, as well as by insufficient storage facilities for jet fuel in certain regions of China.

Prior to 1994, domestic jet fuel prices were generally below international jet fuel prices. The Chinese Government had gradually increased domestic jet fuel prices in order to reflect more accurately the costs of supplying jet fuel in China. As a result, domestic jet fuel prices have become higher than those in the international market since the beginning of 1994. With the WTO entry, the jet fuel price in China will probably be trimmed by the market force to be in line with the international market.

CAOSC s maximum fuel price in 2002 was RMB3,460 per ton. The average price paid by the Group in 2002 was RMB2,715 per ton, which represents a 12.8% decrease from that of 2001.

To address the problem of high jet fuel prices since 2000, CAAC has announced a policy permitting airlines to impose a fuel surcharge on passengers carried by their domestic and Hong Kong regional flights for the purpose of offsetting the effect of rising jet fuel prices. Such surcharges have been imposed by the Group since November 1, 2000 at the prescribed rates set by the CAAC.

In addition to purchases of jet fuel from CAOSC, the Group is also permitted by the Chinese Government to purchase a portion of its jet fuel requirements for its international flights from foreign fuel suppliers located outside China at prevailing international market prices. Jet fuel purchased from such sources outside China accounted for approximately 14.5% of the Group s total jet fuel consumption in 2002.

Flight Operations

Flight operations for the Group s flights originating in Guangzhou are managed by the Company s flight operations and marketing divisions, which are responsible for formulating flight plans and schedules consistent with route and flight approvals received from the CAAC. The Company s flight operations center in Guangzhou is responsible for the on-site administration of flights, including the dispatch and coordination of flights, deployment of aircraft, ground services and crew staffing. In addition, each of the Airline Subsidiaries maintains flight operations centers at all servicing airports for on-site administration of their flights. The Company s general dispatch offices are responsible for monitoring conditions on the Group s route network, administering the Group s flight plans, collecting and monitoring navigation data and analyzing and monitoring airport conditions.

To enhance its management of flight operations, the Group s computerized flight operations control system (SOC) began operation in May 1999. The system utilizes advanced computer and telecommunications technology to manage the Group s flights on a centralized, real-time basis. The Group believes that the system will assist it to (i) compile flight schedules more efficiently; (ii) increase the utilization of aircraft; (iii) allow real-time tracking of all of the Group s flights; and (iv) improve coordination of the Group s aircraft maintenance and ground servicing functions.

Training of Pilots and Flight Attendants

The Group believes that its pilot training program which was established in cooperation with the CAAC affiliated Beijing Aeronautics and Aviation University (the BAAU) has significantly improved the quality of the training received by the Group s pilots and has helped maintain the quality of the Group s staff of pilots at a level consistent with the expansion of operations called for by the Group s business strategy.

In the Group s pilot training program, trainees have two years of theoretical training at the BAAU. After successful completion of academic and physical examinations, students receive flight training for a period of approximate 20 months at China Southern West Australian Flying College Pty Ltd. (the Australian Pilot College), a company that is 65% owned by the Company and 35% owned by CSAHC. Each student at the Australian Pilot College is required to fly at least 230 hours before being awarded a flight certificate. Graduates of the BAAU and the Australian Pilot College are hired by the Group as trainee pilots after passing a CAAC-administered examination to obtain a pilot license. The total training period for the Group s trainee pilots is approximately five years. About 110 trainee pilots graduated from the Australian Pilot College each year.

As part of the pilot training program, the Group also operates a flight simulator training center in Zhuhai, Guangdong Province (the Zhuhai Training Center), which is equipped with simulators for all models of aircraft currently operated by the Group. Trainee pilots receive their initial training in the operation of a specific aircraft at the Zhuhai Training Center, which also provides training to pilots from other Chinese airlines.

The Group s pilots are required to be licensed by the CAAC, which requires an annual recertification examination. The Group s pilots attend courses in simulator training twice annually and in simulator emergency procedures annually at the Zhuhai Training Center. The Group also conducts regular advanced training courses for captains and captain candidates. Pilots advance in rank based on number of hours flown, types of aircraft flown and their performance history.

The Group conducts theoretical and practical training programs for its flight attendants at its Flight Attendants Training Center in Guangzhou (the Guangzhou Training Center). The Guangzhou Training Center is equipped with computerized training equipment, as well as simulator cabins for all models of aircraft currently operated by the Group. At the Guangzhou Training Center, flight attendants of the Group receive comprehensive training in areas such as in-flight service, emergency evacuation and water rescue.

Ground Services

The Group makes arrangements with airport authorities, other airlines or ground services companies for substantially all ground facilities, including jet-ways, waiting areas, ticket counters and support services buildings, at each airport that it serves. The Group pays landing, parking and other fees to such airports, including Baiyun International Airport in Guangzhou. At domestic airports, such fees are generally determined by the CAAC.

At Baiyun International Airport in Guangzhou, the Group operates its own passenger check-in, cargo, mail and baggage handling, aircraft maintenance and cleaning services. The Group also provides such services to other airlines that operate in Baiyun International Airport.

Ground services at the airports in Shenzhen, Changsha, Wuhan, Zhengzhou and Haikou are primarily operated directly by the Group. Ground services at other airports in China are provided to the Group by local airport authorities or local airlines pursuant to various service agreements. Ground services and other services at airports outside China are provided to the Group by foreign services providers pursuant to various service agreements with such parties. All such agreements of the Group are short-term and otherwise on terms that are customary in the industry.

Air Catering

The Company owns a 51% equity interest in Guangzhou Nanland Air Catering Company Limited (Nanland). Nanland provides in-flight meals, snacks, drinks and related services for all of the Group s flights originating in Guangzhou and substantially all other flights departing from Baiyun International Airport. The Group contracts with various air catering suppliers with respect to in-flight catering services for flights originating from other airports, generally on an annual basis and otherwise on terms that are customary in the industry.

Pursuant to an agreement dated March 24, 2001, Nanland has been providing and will provide in-flight meals to the Xinjiang Airlines, a subsidiary of CSAHC from time to time for a period of one year. The agreement will then be automatically extended annually.

For the year ended December 31, 2002, the amount paid by Xinjiang Airlines to Nanland for the provision of in-flight meals was approximately RMB2.9 million.

Pursuant to an agreement dated September 20, 1999, Xinjiang Airlines has been providing and will provide in-flight meals to the Company for a period of one year. The agreement will then be automatically extended annually. The amount paid by the Group to Xinjiang Airlines for the provision of in-flight meals for the year ended December 31, 2002 was approximately RMB1.1 million.

Cargo and Mail

The Group operates cargo and mail services primarily as part of its passenger transportation services. The Group s cargo business expanded in recent years as a result of increased demand for cargo and mail services between Guangzhou and other destinations in China and Southeast Asia served by the Group. The Group plans to continue to expand its cargo and mail operations as a source of incremental revenue and as a means to improve overall load factors. In April 2000, the Company opened a new international cargo route between Shenzhen and Chicago, the U.S. for international cargo service**.** To further cope with the increased aviation logistics resulting from the growth of international trade as a result of the PRC s entry into World Trade Organisation, the Group took delivery of two Boeing 747-400 freighters in the second half of 2002. The Group conducts its cargo business primarily through its cargo division in Shenzhen. In October 2002, the Group commenced cargo and mail services between Shenzhen, Pudong, and Leige for twice per week with one Boeing 747-400 freighter wet-leased from Atlas. Starting from April 10, 2003, the Group operates its own Boeing 747-400 freighter for the route between Shenzhen, Pudong and Leige twice a week, and three times a week for the route between Pudong and Leige.

Sales, Reservations and Marketing

Passenger Ticket Sales and Reservations

The Group s ticket sales and reservations are conducted by or through independent sales agents and the Group s own network of exclusive sales offices as well as the CAAC s and CSAHC s sales offices. The Group has sales offices in Guangzhou and its other route bases. In addition, the Group maintains regional sales offices in other cities in China, including Beijing and Shanghai. The Group maintains international sales offices in Bangkok, Manila, Hanoi, Ho Chi Minh City, Singapore, Kuala Lumpur, Penang, Jakarta and Phnom Penh in Southeast Asia, as well as in Osaka, Fukuoka, Tokyo, Seoul, Amsterdam, Los Angeles, Sydney, Melbourne and Sharjah.

In Hong Kong, ticket sales and reservations services are provided to the Group by China National Aviation Corporation (a CAAC affiliate) and Nanlung Travel Agency Limited (a subsidiary of CSAHC) for a commission of 12% of the ticket price. The Group also has agency agreements with airlines in the Asia-Pacific region, Europe, the United States and Africa for the processing of ticket sales and reservations on a reciprocal basis. In 2002, approximately 30% of all ticket sales for the Group s scheduled flights were made by the Group s, CAAC s and CSAHC s network of sales offices. The Group also sells tickets and accepts reservations through an extensive network of non-exclusive independent sales agents, substantially all of whom operate in cities throughout China, with the remainder operating principally in Hong Kong and other Southeast Asian destinations served by the Group. Under the agency agreements with these sales agents, the Group pays commissions based on the value of tickets sold. The Group pays independent sales agents in China a commission of 3% of the ticket price, and pays independent sales agents outside China a commission ranging from 5% to 9% of the ticket price. Sales agents are typically permitted to withhold their commission from the proceeds of ticket sales that are remitted to the Group. In 2002, independent sales agents accounted for approximately 70% of the Group s ticket sales for its scheduled flights.

Substantially all of the Group s sales offices and agents in China are linked electronically to the CAAC s computerized ticketing and reservations system, which is in turn linked to all domestic airlines for flights throughout China. The Group has also entered into membership agreements with several international reservation systems, including ABACUS in Southeast Asia, SABRE and GALILEO in the United States, AMADEUS in Europe and INFINI in Japan. These systems facilitate reservations and sales of tickets for the Group s international flights.

Cargo

The Group s cargo and mail services are promoted through its own cargo divisions, Baiyun Xinhua and independent cargo agents both within and outside China that track available space among all airlines. In particular, the Group employs a number of cargo agents in the Pearl River delta region. The Group generally pays such agents a commission of 4% and 5% of the relevant cargo freight rate for domestic and international services, respectively.

Promotional and Marketing Activities

The Group engages in regular promotional and marketing activities in an effort to increase its market share. The Group s promotional and marketing activities for domestic routes emphasize safety, passenger comfort and the frequency of the Group s flights. The Group s promotional and marketing activities for international and Hong Kong regional passengers emphasize the Group s quality of service, extensive route network in China and greater frequency of flights relative to other Chinese airlines. In addition, the Group also promotes and markets its Hong Kong regional and international routes on the basis of price.

The Group has been seeking to increase its name recognition by offering new services to passengers. For example, the Group was the first Chinese airline to provide off-airport check-in services. The Group also offers transfer and baggage thru-handling services to passengers connecting to other airlines, including passengers connecting in Hong Kong for flights to Taiwan.

To enhance relationships with its passengers, the Group has launched two frequent flyer programs, namely the China Southern Airlines Sky Pearl Club , and the Egret Mileage Plus . By the end of 2002, the Group had approximately 2,370,000 members under these programs.

Regulation

The Chinese commercial aviation industry is subject to a high degree of regulation and oversight by the CAAC. Regulations and policies issued or implemented by the CAAC encompass substantially all aspects of airline operations, including the approval of domestic, Hong Kong regional and international route allocation, published airfares, aircraft acquisition, jet fuel prices and standards for aircraft maintenance, airport operations and air traffic control. The Civil Aviation Law, which became effective in March, 1996, provides a

framework for regulation of many of these aspects of commercial aviation activities. Although China s airlines operate under the supervision and regulation of the CAAC, they are accorded an increasingly significant degree of operational autonomy, including with respect to the application for domestic, Hong Kong regional and international routes, the allocation of aircraft among routes, the purchase of flight equipment, the pricing of Hong Kong regional and international air fares within a certain range, the training and supervision of personnel and their day-to-day operations.

As an airline providing services on international routes, the Group is also subject to a variety of bilateral civil air transport agreements that provide for the exchange of air traffic rights between China and various other countries. In addition, China is a contracting state, as well as a permanent member, of the International Civil Aviation Organization (the ICAO), an agency of the United Nations established in 1947 to assist in the planning and development of international air transport, and is a party to many other international aviation conventions. The ICAO establishes technical standards for the international aviation industry. The Group believes that it, in all material respects, complies with all such technical standards.

Route Rights

Domestic Routes. The right of any Chinese airline to carry passengers or cargo on any domestic route must be obtained from the CAAC. Non-Chinese airlines are not permitted to provide domestic air service between destinations in China. The CAAC s policy is to assign a domestic route to the Chinese airline that is best suited to serve the route based, in part, on the location of the airline s main or regional base at the point of origin. Under current regulations, airlines are generally expected to operate mainly from their route bases, and flights within a particular region are expected to be served by airlines based in that region. The Group believes that these regulatory parameters benefit airlines, such as the Group, that have a large number of regional route bases. The CAAC also considers other factors that may make a particular airline suitable to operate a domestic route, including the applicant s general operating authority, compliance with pricing regulations and regulations applicable to safety and service quality, market demand, the ability of the applicant in terms of its existing route, and airport facilities and related support services.

The CAAC considers market conditions for a domestic route in determining whether the route should be allocated to one or more airlines. The CAAC requires the passenger load factor on a particular route to reach 75% before additional flights may be added on that route. Airlines serving the route are given priority for such additional flights, and only if such airlines cannot operate more flights will the CAAC permit another airline to commence service.

Hong Kong Regional Routes. Hong Kong regional routes and landing rights are derived from agreements between the Chinese Government and the government of the Hong Kong SAR, and between the Chinese Government and the Portuguese government before December 20, 1999 and the government of Macau SAR on and after December 20, 1999. Such rights are allocated by the CAAC among the seven Chinese airlines permitted to fly to Hong Kong or Macau.

The Group understands that the criteria for determining whether a Hong Kong regional route will be allocated to a particular airline, include market demand, the ability of the airline to service the route and the appropriateness of the airline s aircraft for such route. A number of Hong Kong regional routes are operated by Chinese airlines on a charter flight basis. Permission to operate these flights is in theory subject to monthly review by the CAAC and the Hong Kong Civil Aviation Department. The CAAC has informally indicated that it primarily considers market demand and airline capability in granting permission for such flights.

International Routes. International route rights, as well as the corresponding landing rights, are derived from air services agreements negotiated between the Chinese Government, through the CAAC, and the government of the relevant foreign country. Each government grants to the other the right to designate one or more domestic airlines to operate scheduled service between certain destinations within each of such countries. Upon entering into an air services agreement, the CAAC determines the airline to be awarded such routes based on various criteria, including the availability of appropriate aircraft, flight and management personnel, safety record, the overall size of the airline, financial condition and sufficiency of assets to bear civil liabilities in international air services. These route rights may be terminated by the CAAC under special circumstances.

The criteria for determining whether an international route will be allocated to a second airline generally include (i) the terms of the relevant bilateral civil aviation agreement; (ii) consistency with overall national plans and the national interest and the enhancement of reasonable competition; and (iii) whether the international airports to be used are sufficient for the aircraft flown and employ security measures consistent with international standards.

In addition, if the relevant bilateral civil aviation agreement permits more than one Chinese airline to operate a particular international route, the CAAC will only permit a second airline to operate on such route if the number of passengers carried annually exceeds 100,000 and if there is a minimum average load factor of 68% for routes with at least five weekly flights by Chinese airlines, or 80% for routes with four or fewer weekly flights by Chinese airlines.

Air Fare Pricing Policy

Published air fares of Chinese airlines for domestic routes are established by the CAAC and the pricing department of the SDPC. The CAAC determines and adjusts from time to time the published fare for each domestic route based on several factors, including average airline operating costs, market conditions, national transportation requirements and the ability of consumers to pay increased fares.

In November 1997, the CAAC announced that Chinese airlines would be permitted to offer discounts within specified ranges to their customers. In response to this policy, the Group instituted a multiple class airfare pricing policy under which discounted rates were offered on certain air routes and flights within the parameters of the CAAC s policy.

This air fare policy resulted in severe price competition among Chinese airlines. The CAAC believed that this development was not conducive to the healthy development of Chinese airlines, and therefore in late May 1998 required that Chinese airlines may not offer a discount rate which is more than 20% below the published fare.

In February 1999, the CAAC adopted a new air fare policy prohibiting discounting of domestic airfares except for special group of passengers such as teachers, students, touring group and disabled soldiers, etc. The new policy was intended to encourage Chinese airlines to compete on the basis of overall service instead of fares. The Group believes that the stabilization in ticket price to a certain extent contributed to the increase of the Group s revenue and improved its results of operations in 2001.

Published air fares of Chinese airlines for the Hong Kong regional routes are determined by the CAAC and the relevant civil aviation authorities in Hong Kong or Macau, subject to consultation between the relevant Chinese airlines and Hong Kong or Macau airlines. Airlines may offer discounts on flights on their Hong Kong regional routes.

Published air fares of Chinese airlines for international routes are determined through consultation between the relevant Chinese airlines and foreign airlines in accordance with the civil aviation agreements between the Chinese Government and the relevant foreign government, taking into account the international air fare standards established through the International Air Transportation Association. All air fares for international routes must be approved by the CAAC. Discounting of published international air fares is permitted.

Acquisition of Aircraft and Flight Equipment

The CAAC requires all Chinese airlines to acquire their aircraft through China Aviation Supplies Import and Export Corporation (CASC), an entity controlled by the CAAC. If a Chinese airline plans to acquire an aircraft, the airline must first seek approval from the CAAC and SDPC. The airline must, as a condition of approval, provide specific acquisition plans, which are subject to modification by the CAAC and SDPC. If the CAAC and SDPC approve an aircraft acquisition, the airline negotiates the terms of the acquisition with the manufacturer together with CASC because CASC possesses the license required to import or export aircraft, and CASC receives a commission in respect thereof. Most Chinese airlines are also required to acquire their aircraft engines, spare parts and other flight equipment through CASC. The Company and a few other Chinese airlines are permitted to import jet engines and other flight equipment for their own use without the participation of CASC. In the case of the Company, SAIETC acts as its importer agent and is paid an agency fee for its services.

Jet Fuel Supply and Pricing

CAOSC and Bluesky Oil Supplies Company, companies controlled and supervised by the CAAC, are the only jet fuel supply companies in China, with the exception of the joint venture jet fuel supply companies that supply the Shenzhen, Zhuhai and Sanya airports, in each of which CAOSC is a partner. Airlines are generally not permitted to buy jet fuel from other suppliers in their domestic operations, since the direct import of jet fuel for domestic purposes is prohibited. As a result, all Chinese airlines purchase their domestic jet fuel supply requirements (other than in respect of their Shenzhen, Zhuhai or Sanya operations) from the seven regional branches of CAOSC. Jet fuel obtained from such regional branches is purchased at uniform prices throughout China that are determined and adjusted by CAOSC from time to time with the approval of the CAAC and the pricing department of the SDPC based on market conditions and other factors.

Safety

The CAAC has made the improvement of air traffic safety in China a high priority and is responsible for the establishment of operational safety, maintenance and training standards for all Chinese airlines. The Chinese airlines are required to provide monthly flight safety reports to the CAAC, including reports of flight or other incidents or accidents and other safety related problems involving such airline s aircraft occurring during the relevant reporting period. The CAAC periodically conducts safety inspections on individual airlines.

The CAAC oversees the standards of all Chinese airline pilots through its operation of the CAAC Aviation College. The CAAC Aviation College is a monitoring unit located in Tianjin which implements a uniform pilot certification process applicable to all Chinese airline pilots and is responsible for the issuance, renewal, suspension and cancellation of pilot licenses. Every pilot is required to pass CAAC-administered examinations before obtaining a pilot license and is subject to an annual recertification examination.

All aircraft operated by Chinese airlines, other than a limited number of leased aircraft registered in foreign countries, are required to be registered with the CAAC. All aircraft operated by Chinese airlines must have a valid certificate of airworthiness, which is issued annually by the CAAC. In addition, maintenance permits are issued to a Chinese airline only after its maintenance capabilities have been examined and assessed by the CAAC. Such maintenance permits are renewed annually. All aircraft operated by Chinese airlines may be maintained and repaired only by CAAC-certified maintenance facilities, whether located within or outside China. Aircraft maintenance personnel must be certified by the CAAC before assuming aircraft maintenance posts.

Security

The CAAC establishes and supervises the implementation of security standards and regulations for the Chinese commercial aviation industry. Such standards and regulations are based on Chinese laws, as well as standards developed by international commercial aviation organizations. Each airline and airport in China is required to submit to the CAAC an aviation security handbook describing specific security procedures established by such airline or airport for the day-to-day operations of commercial aviation and procedures for staff training on security. Such security procedures must be based on relevant CAAC regulations and international commercial aviation treaties. Chinese airports and airlines that operate international routes must also adopt security measures in accordance with the requirements of the relevant international agreements.

Noise and Environmental Regulation

All airlines in China must comply with the noise and environmental regulations of the PRC State Environmental Protection Agency. Applicable regulations of the CAAC permit Chinese airports to refuse take-off and landing rights to any aircraft that does not comply with noise regulations.

Chinese Airport Policy

The CAAC supervises and manages the administration of most civilian airports in China, including Baiyun International Airport, which is managed by Baiyun International Airport Company, a company directly controlled by the CAAC. Airports in China are also subject to regulation and ongoing review by the CAAC, which determines take-off and landing charges, as well as charges for the use of airports and airport services.

Competition

The CAAC s extensive regulation of the Chinese commercial aviation industry has had the effect of managing competition among Chinese airlines. Nevertheless, competition has become increasingly intense in recent years due to a number of factors, including relaxation of certain regulations by the CAAC, an increase in the number of Chinese airlines and an increase in the capacity, routes and flights of Chinese airlines.

In the Chinese aviation industry, the three dominant airlines are the Group, Air China and China Eastern Airlines (China Eastern). In 2002, these three airlines together controlled approximately 51% of the commercial aviation market in China as measured by passengers carried.

Most major Chinese airlines have in recent years significantly expanded their fleets, while at the same time, passenger traffic has not increased proportionately. This has resulted in a reduction in the passenger load factors for most Chinese airlines. As a result, Chinese airlines are required to be more competitive with respect to, for example, quality of service, including ticketing and reservations, in-flight services, flight scheduling and timeliness.

The Group expects that competition in China s commercial aviation industry will continue to be intense. The Group will also face increasing competition from alternative means of transport, such as highway and rail, as China s transportation infrastructure improves.

Relative to other Chinese airlines, however, the Group believes that it possesses certain competitive advantages. The Group has the most extensive route network and the largest number of regional route bases among Chinese airlines, which the Group believes places it in a favorable position in the route allocation process. The Group also has the largest aircraft fleet of any Chinese airline, which, together with the

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Group s planned aircraft acquisitions, will permit the Group to expand its operations and to improve the deployment of the aircraft in its fleet. The Group also believes that its dominant presence in the populous and economically developed southern and central regions of China provides it with a competitive advantage in attracting new customers and that its fully integrated flight training, aircraft maintenance and air catering operations enable it to achieve and maintain high quality service to its customers.

The following table sets forth the Group s market share of passengers carried, cargo and mail carried and total traffic of Chinese airlines for the years indicated.

	Passengers Carried		Cargo and Mail Carried (tons)		Total Traffic (ton kilometers)	
Year	Industry Total	Group s Share	Industry Total	Group s Share	Industry Total	Group s Share
	(in million)	(% of total)	(in thousand)	(% of total)	(in billion)	(% of total)
1997	56.3	27.1	1,247	25.0	8.7	20.7
1998	57.5	26.2	1,401	24.9	9.3	20.4
1999	60.9	24.8	1,704	22.9	10.6	18.9
2000	67.2	24.9	1,967	22.5	12.3	20.0
2001	75.2	25.4	1,709	23.3	14.1	21.5
2002	85.9	25.0				