CHINA SOUTHERN AIRLINES CO LTD
Form 20-F
June 30, 2004

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*As filed with the Securities and Exchange Commission on June 30, 2004*

# *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, 2003*

*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, 1,174,178,000 ordinary H Shares of par value RMB1.00 per share and 1,000,000,000 ordinary A Shares of par value RMB1.00 per share were issued and outstanding as of December 31, 2003.*

*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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**China Southern Airlines Company Limited**

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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;
- 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 50.3% controlling interest in the Company.

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 consolidated financial statements in Renminbi. The consolidated financial statements of the Company as of December 31, 2002 and 2003 (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 significant respects from accounting principles generally accepted in the United States of America ( U.S. GAAP ). Information relating to the nature and effect of such differences is presented in Note 33 to the Financial Statements.

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 = RMB8.2767, 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, 2003. 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.

## 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 data of consolidated statements of operations for each of the years in the five-year period ended December 31, 2003 and consolidated balance sheets for five years ended December 31, 2003 have been derived from the consolidated financial statements of the Company. Such consolidated financial statements have been audited by KPMG, Independent Registered Public Accounting Firm, and prepared in accordance with IFRS. IFRS differs in certain significant respects from U.S. GAAP. See Note 33 to the Financial Statements for the nature and effect of such differences related to the Group between IFRS and U.S. GAAP as of December 31, 2002 and 2003 and for each of the years in the three-year period ended December 31, 2003. 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, | | | |
|---|---|---|---|---|---|---|
| | **1999** | **2000** | **2001** | **2002** | **2003** | **2003** |
| | **RMB** | **RMB** | **RMB** | **RMB** | **RMB** | **US$** |
| | (in million, except per share data) | | | | | |
| **Income Statement Data:** | | | | | | |
| IFRS: | | | | | | |
| Operating revenue | 13,299.6 | 15,178.3 | 16,879.7 | 18,018.6 | 17,470.1 | 2,110.8 |
| Operating expenses | 11,449.7 | 13,996.2 | 15,479.0 | 15,992.5 | 17,014.4 | 2,055.7 |
| Operating income | 1,849.9 | 1,182.1 | 1,400.7 | 2,026.1 | 455.7 | 55.1 |
| Equity income of affiliated companies | 36.1 | 45.9 | 53.0 | 37.0 | 47.8 | 5.8 |
| Equity loss of jointly controlled entities | | | (4.0) | (3.4) | (39.5) | (4.8) |
| (Loss)/gain on sale of fixed assets | (18.7) | 372.6 | (55.9) | 170.7 | (22.2) | (2.7) |
| Interest expense | (1,192.2) | (1,074.2) | (933.7) | (959.2) | (823.7) | (99.5) |
| Exchange (loss)/gain, net | (426.5) | 318.5 | 296.8 | (175.4) | (164.4) | (19.9) |
| Other, net | 119.9 | 86.3 | 38.4 | 43.3 | 34.7 | 4.2 |
| Income/(loss) before taxation and minority interests | 368.5 | 931.2 | 795.3 | 1,139.1 | (511.6) | (61.8) |
| Taxation (expense)/credit | (128.0) | (338.9) | (320.5) | (398.2) | 324.2 | 39.2 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Minority interests | (158.1) | (90.5) | (134.6) | (165.1) | (170.9) | (20.7) |
| Net income/(loss) | 82.4 | 501.8 | 340.2 | 575.8 | (358.3) | (43.3) |
| Basic earnings/(loss) per share | 0.02 | 0.15 | 0.10 | 0.17 | (0.09) | (0.01) |
| Basic earnings/(loss) per ADS | 1.22 | 7.44 | 5.04 | 8.53 | (4.68) | (0.56) |
| Cash dividends declared per share | | | | 0.02 | | |
| U.S. GAAP: | | | | | | |
| Net income/(loss) | 370.3 | 354.4 | 430.7 | 474.0 | (359.6) | (43.5) |
| Basic earnings/(loss) per share | 0.11 | 0.11 | 0.13 | 0.14 | (0.09) | (0.01) |
| Basic earnings/(loss) per ADS | 5.49 | 5.25 | 6.38 | 7.02 | (4.69) | (0.57) |
| Cash dividends declared per share | | | | 0.02 | | |

| | December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 | 2003 |
| | RMB | RMB | RMB (in million) | RMB | RMB | US$ |
| **Balance Sheet Data:** | | | | | | |
| IFRS: | | | | | | |
| Cash and cash equivalents | 4,588.4 | 4,197.5 | 2,817.9 | 3,771.0 | 2,080.2 | 251.3 |
| Other current assets | 1,715.2 | 1,691.9 | 1,560.5 | 1,834.8 | 1,921.3 | 232.1 |
| Fixed assets, net | 24,211.2 | 23,282.1 | 22,352.2 | 26,920.8 | 28,535.9 | 3,447.7 |
| Total assets | 32,557.7 | 30,924.0 | 30,653.1 | 37,188.0 | 39,062.1 | 4,719.5 |
| Notes payable, including current installments of long term notes payable | 613.3 | 783.1 | 2,177.5 | 5,240.7 | 7,096.8 | 857.4 |
| Current installments of obligations under capital leases | 1,999.7 | 1,776.2 | 1,451.9 | 1,566.7 | 1,297.9 | 156.8 |
| Notes payable, excluding current installments | 4,424.2 | 3,788.7 | 3,627.6 | 5,835.4 | 4,521.7 | 546.3 |
| Obligations under capital leases, excluding current installments | 11,490.9 | 9,416.3 | 7,691.6 | 6,631.8 | 5,543.1 | 669.7 |
| Shareholders equity | 8,379.7 | 8,881.4 | 9,221.7 | 9,613.2 | 11,895.7 | 1,437.3 |
| U.S. GAAP: | | | | | | |
| Shareholders equity | 8,227.4 | 8,527.3 | 8,958.0 | 9,287.3 | 11,568.5 | 1,397.7 |

Selected Operating Data

The following selected operating data of the Group for the five years ended December 31, 2003 have been derived from consolidated 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 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 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 for year 1999, the operating data and the profit analysis and comparison for other years 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, | | | | |
|---|---|---|---|---|---|
| | **1999** | **2000** | **2001** | **2002** | **2003** |
| **Capacity** | | | | | |
| ASK (million) | | | | | |
| Domestic | 24,900 | 28,345 | 31,393 | 33,753 | 32,590 |
| Hong Kong regional | 1,791 | 1,744 | 1,690 | 1,746 | 1,347 |
| International | 5,155 | 5,742 | 6,981 | 8,746 | 6,930 |
| Total | 31,846 | 35,831 | 40,064 | 44,245 | 40,867 |
| ATK (million) | | | | | |
| Domestic | 2,865 | 3,322 | 3,622 | 3,924 | 3,772 |
| Hong Kong regional | 214 | 198 | 185 | 193 | 150 |
| International | 683 | 1,087 | 1,317 | 1,798 | 1,999 |
| Total | 3,762 | 4,607 | 5,124 | 5,915 | 5,921 |

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| | Year ended December 31, | | | | |
|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 |
| Kilometers flown (thousand) | 182,200 | 209,431 | 234,051 | 258,379 | 249,068 |
| Hours flown (thousand) | 287 | 326 | 365 | 405 | 385 |
| Number of flights | | | | | |
| Domestic | 126,120 | | | | |
| Hong Kong regional | 13,460 | | | | |
| International | 6,600 | | | | |
| Total | 146,180 | | | | |
| Number of landing and take-offs | | | | | |
| Domestic | | 165,726 | 183,651 | 194,776 | 191,460 |
| Hong Kong regional | | 14,255 | 13,712 | 13,891 | 11,400 |
| International | | 8,861 | 10,698 | 13,990 | 11,330 |
| Total | | 188,842 | 208,061 | 222,657 | 214,190 |
| **Traffic** | | | | | |
| RPK (million) | | | | | |
| Domestic | 14,511 | 16,974 | 19,447 | 22,092 | 21,294 |
| Hong Kong regional | 1,106 | 1,074 | 1,060 | 1,081 | 778 |
| International | 3,068 | 3,605 | 4,550 | 5,767 | 4,315 |
| Total | 18,685 | 21,653 | 25,057 | 28,940 | 26,387 |
| RTK (million) | | | | | |
| Domestic | 1,518 | 1,941 | 2,217 | 2,532 | 2,424 |
| Hong Kong regional | 106 | 107 | 105 | 108 | 78 |
| International | 379 | 565 | 712 | 974 | 1,059 |
| Total | 2,003 | 2,613 | 3,034 | 3,614 | 3,561 |
| Passengers carried (thousand) | | | | | |
| Domestic | 12,769 | 14,450 | 16,499 | 18,535 | 18,259 |
| Hong Kong regional | 1,434 | 1,444 | 1,409 | 1,369 | 1,019 |
| International | 909 | 957 | 1,213 | 1,589 | 1,192 |
| Total | 15,112 | 16,851 | 19,121 | 21,493 | 20,470 |
| Cargo and mail carried (tons) | 390,750 | 353,000 | 398,000 | 470,000 | 464,000 |
| **Load Factors** | | | | | |
| Passenger load factor (RPK/ASK) (%) | | | | | |
| Domestic | 58.3 | 59.9 | 61.9 | 65.5 | 65.3 |
| Hong Kong regional | 61.8 | 61.6 | 62.7 | 61.9 | 57.8 |
| International | 59.5 | 62.8 | 65.2 | 65.9 | 62.3 |
| Total | 58.7 | 60.4 | 62.5 | 65.4 | 64.6 |
| Overall load factor (RTK/ATK) (%) | | | | | |
| Domestic | 53.0 | 58.4 | 61.2 | 64.5 | 64.2 |
| Hong Kong regional | 49.5 | 54.0 | 56.8 | 55.8 | 52.2 |
| International | 55.5 | 52.0 | 54.1 | 54.2 | 53.0 |
| Total | 53.2 | 56.7 | 59.2 | 61.1 | 60.1 |
| Breakeven load factor (%) | 47.5 | 54.0 | 55.6 | 55.9 | 61.6 |
| **Yield** | | | | | |
| Yield per RPK (RMB) | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| Domestic | 0.65 | 0.62 | 0.62 | 0.55 | 0.57 |
| Hong Kong regional | 1.00 | 1.06 | 1.06 | 0.98 | 0.96 |
| International | 0.42 | 0.43 | 0.41 | 0.42 | 0.47 |
| Total | 0.63 | 0.61 | 0.60 | 0.54 | 0.57 |
| Yield per cargo and mail ton kilometers (RMB) | 1.63 | 2.13 | 1.76 | 1.73 | 1.62 |

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| | Year ended December 31, | | | | |
|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 |
| Yield per RTK (RMB) | | | | | |
| Domestic | 6.69 | 5.90 | 5.83 | 5.21 | 5.40 |
| Hong Kong regional | 11.00 | 11.19 | 11.26 | 10.36 | 10.35 |
| International | 3.96 | 3.63 | 3.31 | 3.25 | 2.90 |
| Total | 6.40 | 5.63 | 5.43 | 4.84 | 4.76 |
| **Fleet** | | | | | |
| Boeing | 81 | 89 | 91 | 102 | 108 |
| Airbus | 20 | 20 | 20 | 20 | 24 |
| Total aircraft in service at period end | 101 | 109 | 111 | 122 | 132 |
| Overall utilization rate (hours per day) | 8.1 | 8.7 | 9.1 | 9.8 | 8.5 |
| **Financial** | | | | | |
| Operating cost per ASK (RMB) | 0.36 | 0.39 | 0.39 | 0.36 | 0.42 |
| Operating cost per ATK (RMB) | 3.04 | 3.04 | 3.02 | 2.70 | 2.87 |

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** | | | | |
| 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 |
| 2003 | 8.2767 | 8.2772 | 8.2800 | 8.2769 |

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 2003 | 8.2772 | 8.2765 |
| January 2004 | 8.2772 | 8.2767 |
| February 2004 | 8.2773 | 8.2769 |

| | | |
|---|---|---|
| March 2004 | 8.2774 | 8.2767 |
| April 2004 | 8.2772 | 8.2768 |
| May 2004 | 8.2773 | 8.2768 |
| June 2004 (up to June 25, 2004) | 8.2768 | 8.2767 |

(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, 2003. The Board of Directors of the Company ( Board of Directors ) does not recommend the payment of a final dividend in respect of the year ended December 31, 2003.

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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 50.3% 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, H Shares and A 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, 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, as the Group 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 incurred a net exchange loss of RMB175 million and RMB164 million for 2002 and 2003, respectively, mainly as a result of yen fluctuations. A majority of these exchange losses 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 financial services. In addition, Mr. Yan Zhi Qing, the Chairman of the 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 CSAHC s 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 Company. 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, 2002 and 2003, the Group had short-term deposits of RMB901 million and RMB366 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.

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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. 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.

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 jointly controlled entity, 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 is 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

*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 encompasses 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 2003 accounted for 22.7% 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, sometimes 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. 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*

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, 26.8% 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 is lifted.

*Consolidation and Restructuring*

In 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 and China Eastern Air Holding Group. The Company announced that it will also participate in such consolidation and restructuring pursuant to the CAAC directives. The Company has taken steps towards the purchase of the airline business of China Northern Airlines Company and Xinjiang Airlines Company, two wholly owned subsidiaries of CSAHC. These proposed acquisitions 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, 2003, 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 RMB152 million (US$18 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*

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 be 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 50.3% owned by CSAHC. The registered address of the Company is Guangzhou Economic & Technology Development Zone, People s Republic of China (telephone no: (86)20-8612-4738, website: www.cs-air.com).

During 2001, the Company established a new 50%: 50% joint venture, namely MTU Maintenance Zhuhai Co. Ltd, with MTU Maintenance Gmbh, a subsidiary of Daimler-Benz Aerospace Group, to provide repair and maintenance services to aircraft engines. The registered capital is US$63.1 million.

During 2002, the Company 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 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, the Company paid RMB136.5 million (equivalent to approximately US$16.5 million) to acquire 39% interest in Sichuan Airlines Corporation Limited to further expand its market shares in South-western China. The Group also jointly established a new 51%: 49% joint venture, namely Zhuhai Xiang Yi Aviation Technology Company Limited, the first sino-foreign joint venture company engaging in aviation training services in the PRC, with CAE. The registered capital is US$29.8 million.

On March 13, 2003, the Company obtained an approval certificate from the Ministry of Commerce to change to a permanent limited company with foreign investments and obtained the business license on October 17, 2003 issued by the State Administration of Industry and Commerce of the People s Republic of China.

Pursuant to an extraordinary general meeting of shareholders held on May 21, 2002, a resolution was passed authorizing the Company to issue not more than 1,000,000,000 A shares of par value of RMB1.00 each. The Company issued and listed its 1,000,000,000 A shares with a par value of RMB1.00 each on the Shanghai Stock Exchange in July 2003.

On October 17, 2003, the Company s registered address was moved to Guangzhou Economic & Technology Development Zone. In accordance with the Rules and Regulations for Implementation of Income Tax for Foreign Investment Enterprises and Foreign Enterprises of the PRC and a taxation approval document Guangzhou Municipal State Tax Bureau Suo De Shui Zi Que 020043 , the Company is entitled to enjoy the preferential tax policy implemented in the Guangzhou Economic & Technology Development Zone effective October 1, 2003. As a result, the Company s income tax rate has been changed to 15% from 33% beginning from that date.

The Group had RMB1,492 million, RMB6,351 million and RMB4,707 capital expenditures in 2001, 2002 and 2003 respectively. Of such capital expenditures in 2003, RMB2,818 million were financed by bank borrowings while the remaining RMB1,889 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 other facilities and building for operations.

The Chinese Government has approved a new Guangzhou airport project, which commenced construction in 2000, with completion targeted in August 2004. 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, 2003, the Group invested a total of RMB1,445.8 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.

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**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 2003, 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, 2003, the Group s RPKs increased at a compound annual rate of 2.6%, from 25,057 million in 2001 to 26,387 million in 2003, while its capacity, measured in terms of ASKs, increased at a compound annual rate of 1.0%, from 40,064 million in 2001 to 40,867 million in 2003. In 2003, the Group carried 20.47 million passengers and had passenger revenue of RMB15,010 million (US$1,814 million). Net loss for 2003 was RMB358 million (US$43 million).

The Group conducts a portion of its airline operations through its airline subsidiaries namely 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 2003, the Airline Subsidiaries carried 7.62 million passengers and had operating revenue of RMB5,368 million (US$608 million) and accounted for 37.2% and 30.7% of the Group s passengers carried and operating revenue, respectively.

The Group also provides air cargo and mail services. The cargo and mail revenue of the Group increased by 9.5% to RMB1,955 million (US$236 million) in 2003 as compared with 2002. The Group s airline operations are fully integrated with its airline-related businesses, including aircraft and engine maintenance, flight simulation and air catering operations.

The Group operates the most extensive route network among Chinese airlines with a total of 334 routes as of December 31, 2003, including 274 domestic routes, 18 Hong Kong regional routes (which include Hong Kong routes and Macau routes), and 42 international routes. In 2003, the Group operated an average of 4,118 landing and take-offs per week serving 94 destinations, including major cities in China, such as 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 twelve regional route bases in Zhengzhou, Wuhan, Changsha, Shenzhen, Zhuhai, Xiamen, Fuzhou, Haikou, Guilin, Beihai, 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 2003, the Group had 18 Hong Kong regional routes and 42 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 Tokyo, 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 2003, the Group operated a fleet of 132 aircraft, consisting primarily of Boeing 737-300, 737-500, 737-700, 737-800, 747-400, 757-200 and 777-200 aircraft, and Airbus 319-100 and 320-200 aircraft. Significant portions of these aircraft are held under capital and operating leases. The average age of the Group s aircraft was 7.82 years at year end 2003.

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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. Domestic Shares and H Shares are both ordinary shares of the Company.

Pursuant to an extraordinary general meeting of shareholders held on May 21, 2002, a resolution was passed authorizing the Company to issue not more than 1,000,000,000 A shares of par value of RMB1.00 each. The Company issued and listed its 1,000,000,000 A shares with a par value of RMB1.00 each on the Shanghai Stock Exchange in July 2003. Subsequent to A share issue, the shareholding of CSAHC on the Company was reduced to 50.3% from 65.2%.

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 (decrease) over previous year** | **Total** | **Increase (decrease) over previous year** |
| | **(in million)** | **(%)** | **(in thousand)** | **(%)** | **(in million)** | **(%)** |
| 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 |
| 2003 | 20.47 | (4.7) | 464.0 | (1.3) | 3,561.0 | (1.5) |

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Route Network

*Overview*

The Group operates the most extensive route network among Chinese airlines. As of year end 2003, the Group operated 334 routes consisting of 274 domestic routes, 18 Hong Kong regional routes and 42 international routes. At such date, the Group s route network served 71 destinations within China and 23 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 order to expand the Group s international route network, the Group has entered into code-sharing agreements with several international airlines such as Delta Airlines, Asiana Airlines, Japan Air System, Vietnam Airlines, Royal Dutch Airlines and Garuda Indonesian, etc. Under the code sharing agreements, the airlines are permitted to sell tickets on certain international routes for the Group to passengers using their codes. Similarly, the Group is permitted to sell tickets for these airlines using its CZ code. The code sharing agreements help increase the number of the Group s international sales outlets.

*Route Bases*

The Group s main route base is in Guangzhou. The Group maintains twelve regional route bases in Zhengzhou, Wuhan, Changsha, Shenzhen, Zhuhai, Xiamen, Fuzhou, Haikou, Guilin, Beihai, 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 in August 2004. 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, 2003, the Group invested a total of RMB1,445.8 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 2003, the Group s most profitable domestic routes were the routes between Guangzhou and Beijing, Guangzhou and Shanghai, Shenzhen and Shanghai, Beijing and Guangzhou, Shenzhen and Beijing, Shanghai and Guangzhou, Beijing and Shenzhen, Guangzhou and Zhengzhou, Zhengzhou and Guangzhou and between Guangzhou, Dalian and Harbin.

*Hong Kong Regional Routes*

The Group offers scheduled service between Hong Kong and Guangzhou, Kunming, Xiamen, Shantou, Beijing, Guilin, Meixian, Haikou, Wuhan, Zhengzhou, Nanning, Changsha and Sanya; between Macau and Fuzhou, Hangzhou and Xiamen. The Group s Hong Kong regional routes also include routes between Hong Kong or Macau and other destinations in China, including Zhang Jia Jie and Wu Yi Shan, 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 2003, the most profitable Hong Kong regional routes were those between Guangzhou and Hong Kong, Hong Kong and Guangzhou, Hong Kong and Wuhan, Wuhan and Hong Kong, Kunming and Hong Kong, Hong Kong and Xiamen, Hong Kong and Zhengzhou, Hong Kong and Kunming, Zhengzhou and Hong Kong, Hong Kong and Changsha.

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 2003, the Group operated a total of 11,395 flights on its Hong Kong regional routes, accounting for approximately 29.8% 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 24 routes serving ten Southeast Asian destinations, including Singapore and major cities in Indonesia, Thailand, Malaysia, Philippines, Vietnam and Laos. In 2003, the Group s most profitable Southeast Asian routes were those between Manila, Xiamen and Beijing; Beijing, Xiamen and Manila; Guangzhou and Singapore, and Guangzhou and Bankok. 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 24 routes serving ten Southeast Asian destinations, the Group also operates 18 other international routes providing scheduled service to Amsterdam, Sharjah, Osaka, Tokyo, Fukuoka, Seoul, Los Angeles, Sydney and Melbourne.

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 2003, the Group operated a fleet of 132 aircraft with an average age of 7.82 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 132 aircraft as of December 31, 2003.

| Model | Number of Aircraft | Average Age (years) | Average Passenger Capacity |
|---|---|---|---|
| Boeing 777-200 | 4 | 7.51 | 380 |
| Boeing 777-21B | 5 | 6.27 | 292 |
| Boeing 757-200 | 25 | 11.48 | 200 |
| Boeing 747F | 2 | 1.42 | n/a |
| Boeing 737-800 | 12 | 0.78 | 167 |
| Boeing 737-700 | 10 | 3.39 | 138 |
| Boeing 737-500 | 18 | 11.10 | 132 |
| Boeing 737-300 | 32 | 10.16 | 145 |
| Airbus 319-100 | 4 | 0.42 | 128 |
| Airbus 320-200 | 20 | 5.64 | 158 |
| | 132 | | |

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During 2003, the Group continued to expand and modernize its aircraft fleet. In 2003, the Group s major aircraft transactions included:

(i) The acquisition of seven Boeing 737-800 aircraft financed by a combination of internal funds and long term bank loans;

(ii) The addition of four Airbus 319-100 aircraft and three Boeing 737-700 aircraft under operating leases;

(iii) The early retirement of two Boeing 737-200 aircraft;

(iv) The expiry of two Boeing 747 cargo freighters under short-term wet leases; and

(v) The extension of four Boeing 737-300 under operating leases for another 2 to 5 years.

In addition, on April 8, 2004, the Company entered into an agreement with Airbus SNC for the acquisition of fifteen Airbus 320-200 aircraft and six Airbus 319-100 aircraft, scheduled for deliveries in 2005 and 2006.

Aircraft Financing Arrangements

*Overview*

A significant portion of the Group s aircraft is acquired 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, 2003, 29 of the Group s 132 aircraft were operated under capital leases, 54 were operated under operating leases, 27 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 acquisition of aircraft in the foreseeable future will generally be made pursuant to operating leases or financed by long-term mortgaged loans. 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, 2003, 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 | 5 | 3 | 7.66 |
| Boeing 757-200 | 1 | 10 | 4.78 |
| Boeing 737-700 | | 4 | 6.13 |
| Boeing 737-500 | | 18 | 2.28 |
| Boeing 737-300 | 5 | 13 | 3.24 |
| Airbus 320-200 | 18 | 2 | 4.60 |
| Airbus 319-100 | | 4 | 9.57 |
| | 29 | 54 | |

*Capital Leases*

As of December 31, 2003, the Group s aggregate future minimum lease payments (including future finance charges) required under its capital leases were RMB7,961 million (US$962 million). As of year end 2003, a majority of the Group s capital leases had original terms ranging from ten to fifteen years from the date of delivery of the relevant aircraft, and the remaining terms of these leases ranged from one to six years. The Group s capital leases typically cover a significant 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, 2003, the Group s aggregate future minimum lease payments required under its operating leases were RMB8,120 million (US$981 million). As of year end 2003, the Group s operating leases had original terms generally ranging from eight to ten years from the date of delivery of the relevant aircraft, and the remaining terms of these leases generally ranged from one to nine 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.

Pursuant to capital or operating leases, the Group is obligated to indemnify the lessors against any withholding or similar taxes that may be imposed on the lessors by taxing authorities in China with regard to payments made pursuant to such leases. In accordance with relevant PRC tax regulations, a PRC lessee is liable to pay PRC withholding tax in respect of any lease payments regularly made to an overseas lessor. Depending on the circumstances, this tax is generally imposed at a fixed rate ranging from 10% to 20% of the lease payments, or in certain cases, the interest components of such payments. Pursuant to an approval document from the State Taxation Bureau, lease arrangements executed prior to September 1, 1999 are exempt from PRC withholding tax. The PRC withholding tax payable in respect of the operating leases executed after September 1, 1999 of RMB12 million, RMB14 million and RMB8 million during 2001, 2002 and 2003 respectively, have been included as part of the operating lease charges.

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 2003, 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.

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### 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 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 12 other Chinese airlines and 11 international airlines. GAMECO provides heavy maintenance services to 11 other Chinese airlines and seven international airlines.

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, 2003, GAMECO s revenue (excluding Value Added Tax) totaled RMB569 million, approximately 88.2% 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. Starting from 2003, MTU Maintenance Zhuhai Co., Ltd., ( MTU Zhuhai ) a jointly controlled entity of the Company and MTU Aero Engines Gmbh., also performed overhauls of certain jet engines for the Group. For the year ended December 31, 2003, a total of eleven jet engines were major overhauled by MTU Zhuhai with total repair costs of RMB106 million.

### 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, 2003. 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 0.19, 0.42 and 0.13 in 2001, 2002 and 2003, respectively. In comparison, CAAC s published maximum acceptable flight incident ratio was 1.6 in 2001 and 1.5 in 2002 and 1.3 in 2003. 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 2003 accounted for 22.7% 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 National Development and Reform Commission ( NDRC ) 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 2003 was RMB3,500 per ton. The average price paid by the Group in 2003 was RMB3,074 per ton, which represents a 13.2% increase from that of 2002.

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 10.0% of the Group s total jet fuel consumption in 2003.

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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 approximately 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.

Prior to January 2003, as part of the pilot training program, the Group also operated a flight simulator training center in Zhuhai, Guangdong Province (the Zhuhai Training Center ), which was equipped with simulators for all models of aircraft currently operated by the Group. Trainee pilots received their initial training in the operation of a specific aircraft at the Zhuhai Training Center, which also provided training to pilots from other Chinese airlines. Such flight simulation training has been shifted to Zhuhai Xiang Yi Aviation Technology Company Limited ( Zhuhai Xiang Yi), a jointly controlled entity between the Company and CAE International Holdings Limited, since January 2003. Zhuhai Xiang Yi currently leases the flight simulation facilities of Zhuhai Training Center from the Group and provides flight simulation training services to the Group.

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. 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.

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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, Haikou, Zhuhai, Xiamen, Fuzhou, Guilin, Shantou, Guiyang and Beihai 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.

Cargo and Mail

The Group also provides air cargo and mail services. Previously, a significant portion of these services is combined with passenger flights services. Currently, the Group has two Boeing 747-400 freighters servicing three international cargo routes, Shenzhen to Chicago and Belgium and Shanghai to Amsterdam. Route Shanghai to Amsterdam was newly opened in October 2003. In October 2003, the Group took delivery of its first Boeing 737-300 QC (Quick Change) cargo aircraft. The QC aircraft is designed to provide maximum utilization of aircraft by allowing passenger use during the day and cargo operations at night.

Currently, the Group conducts its cargo business primarily through its cargo division in Shenzhen. To further tap into the growing cargo market, the Group has commenced the construction of a cargo centre in the Guangzhou new airport in 2003, at a cost of Rmb190 million.

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 sales offices and CSAHC s affiliates. 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 and Nanlung Travel Agency Limited (a subsidiary of CSAHC) for a commission of 3% 9% 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 2003, approximately 30% of all ticket sales for the Group s scheduled flights were made by the Group s and CAAC s network of sales offices and CSAHC s affiliates. 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 2003, 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 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 2003, the Group had approximately 3,041,200 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 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 NDRC. 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. Airlines may offer discounts within a range specified by the CAAC under certain circumstances.

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 Transport 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 NDRC. The airline must, as a condition of approval, provide specific acquisition plans, which are subject to modification by the CAAC and NDRC. If the CAAC and NDRC 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 NDRC 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.

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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 regulates all civilian airports in China. The local government of the PRC manages the administration of most civilian airports in China, including Baiyun International Airport as of 2004, with limited exceptions. 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 2003, these three airlines together controlled approximately 56% 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 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 and engine 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.

| Year | Passengers Carried | | Cargo and Mail Carried (tons) | | Total Traffic (ton kilometers) | |
|---|---|---|---|---|---|---|
| | **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 | 2,021 | 23.3 | 16.5 | 21.9 |
| 2003 | 87.6 | 23.4 | 2,190 | 21.2 | 17.1 | 20.8 |

*Domestic Routes*

The Group competes against its domestic competitors primarily on the basis of flight schedule, route network, quality of service, safety, type and age of aircraft and, to a lesser extent and until recently, price. The Group competes against nine other Chinese airlines in its various domestic route markets. Of these competitors, the largest are two airlines owned or controlled by the Chinese Government, and the remaining six airlines are operated by or under the control of various Chinese provincial or municipal governments.

The following table sets forth the Group s market share of the passengers carried, cargo and mail carried on departing flights and total departing flights at the ten busiest airports in China, based on passenger volume, in 2003.

| Airport | Passengers Carried (% of total) | Cargo and Mail Carried (% of total) | Departing Flights (% of total) |
|---|---|---|---|
| Beijing | 12.1 | 11.0 | 10.8 |
| Shanghai Hongqiao | 15.4 | 8.3 | 15.9 |
| Guangzhou | 51.0 | 40.7 | 50.3 |
| Shenzhen | 27.9 | 28.0 | 24.9 |
| Kunming | 15.0 | 12.3 | 14.2 |
| Chengdu | 11.0 | 14.5 | 10.0 |
| Haikou | 25.3 | 33.6 | 19.5 |
| Xian | 8.6 | 11.3 | 6.2 |
| Shanghai Pudong | 7.8 | 7.0 | 7.9 |
| Hangzhou | 26.5 | 20.7 | 27.2 |

The following table sets forth the Group s market share of the passengers carried, cargo and mail carried on departing flights and total departing flights at seven busiest airports in southern and central China (excluding

Guangzhou, Shenzhen and Haikou, which are included in the table above), based on passenger volume, in 2003.

| **Airport** | **Passengers Carried (% of total)** | **Cargo and Mail Carried (% of total)** | **Departing Flights (% of total)** |
|---|---|---|---|
| Wuhan Tianhe | 43.6 | 45.1 | 38.1 |
| Changsha | 40.4 | 42.5 | 35.7 |
| Zhengzhou | 68.1 | 67.1 | 54.1 |

| Airport | Passengers Carried (% of total) | Cargo and Mail Carried (% of total) | Departing Flights (% of total) |
|---|---|---|---|
| Guiyang | 32.6 | 44.9 | 29.3 |
| Shantou | 77.6 | 67.9 | 69.4 |
| Guilin | 36.8 | 22.9 | 35.6 |
| Zhuhai | 60.8 | 62.3 | 28.8 |
| Xiamen | 61.3 | 38.7 | 55.8 |

*Hong Kong Regional Routes*

The Group dominates the routes operated by Chinese airlines between Hong Kong and Macau and China. In 2003, the Group operated an average of more than 219 charter and other scheduled flights per week between China and Hong Kong or Macau, accounting for approximately 29.8% of the total number of passengers carried by all Chinese airlines on the Hong Kong regional routes. The Group believes that the routes on which it operates 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. Dragon Air, which is a Hong Kong-based airline, competes with the Group on many of the Group s Hong Kong regional routes.

Air Macau Group Ltd. ( Air Macau ), a Macau-based airline, started to operate routes in 1996 between Macau and China, including destinations such as Beijing, Shanghai, Xiamen and Wuhan. Air Macau also operates routes between Macau and Taiwan, including flights which allow passengers to travel between Taiwan and China through Macau. The air fares on some of Air Macau s routes are significantly less than air fares on comparable routes of the Group. Air Macau s routes provide an alternative to and compete with the Group s Hong Kong regional routes for passengers travelling between Taiwan and China.

*International Routes*

The Group competes with Air China, China Eastern and many well-established foreign airlines on its international routes. Most of these international competitors have significantly longer operating histories, substantially greater financial and technological resources and greater name recognition than the Group. In addition, the public s perception of the safety and service records of Chinese airlines may adversely affect the Group s ability to compete against its Hong Kong regional and international competitors. Many of the Group s international competitors have larger sales networks and participate in reservation systems that are more comprehensive and convenient than those of the Group, or engage in promotional activities that may enhance their ability to attract international passengers.

Air China has the most extensive international route network among Chinese airlines. Beijing, the hub of Air China s operations, has been the destination for most international flights to China. The Group competes against, among other airlines, Thai Airways International, Singapore Airlines, Malaysian Airlines System, Air China and China Eastern on flights to Southeast Asian destinations. In the case of its European routes, the Group s competitors include KLM-Royal Dutch Airlines. The Group faces competition on its international route from Air China and China Eastern, each of which operates several routes between destinations in China and the United States, as well as international airlines that fly to Los Angeles from Hong Kong. The Group competes in the international market primarily on the basis of safety, price, timeliness and convenience of scheduling.

Airline Subsidiaries

The Airline Subsidiaries are joint ventures established by the Company and local companies in the provinces or special economic zones where the Airline Subsidiaries are based and are engaged in providing airline and related services. The Company owns 60% equity interest in each of the Airline Subsidiaries.

As of December 31, 2003, Xiamen Airlines operated under its own MF code a fleet of 27 aircraft on 81 domestic routes, five international route and four Hong Kong regional routes. In 2003, Xiamen Airlines carried a total of about 4.91 million passengers, or approximately 24.0% of the passengers carried by the Group in that year, and had RMB3,460 million in operating revenue.

As of December 31, 2003, Shantou Airlines operated under the Group s CZ code 5 aircraft on 52 domestic routes and two Hong Kong regional route. In 2003, Shantou Airlines carried a total of about 742,000 passengers, or 3.6% of the passengers carried by the Group in that year. Total operating revenue of Shantou Airlines for the year ended December 31, 2003 was RMB546 million.

As of December 31, 2003, Guangxi Airlines operated under the CZ code 5 aircraft on 34 domestic routes, two international routes and three Hong Kong regional routes. In 2003, Guangxi Airlines carried a total of about 678,000 passengers, or 3.3% of the total number of passengers carried by the Group in that year. Total operating revenue of Guangxi Airlines for the year ended December 31, 2003 was RMB457 million.

As of December 31, 2003, Zhuhai Airlines operated under the CZ code 4 aircraft on 34 domestic routes. In 2003, Zhuhai Airlines carried a total of about 602,000 passengers, or approximately 2.9% of the total number of passengers carried by the Group in that year. Total operating revenue of Zhuhai Airlines for the year ended December 31, 2003 was RMB436 million.

As of December 31, 2003, Guizhou Airlines operated under the CZ code 6 aircraft on 19 domestic routes. In 2003, Guizhou Airlines carried a total of about 691,000 passengers, or approximately 3.4% of the total number of passengers carried by the Group in 2003. Total operating revenue of Guizhou Airlines was approximately RMB469 million for the year ended December 31, 2003.

Insurance

The CAAC maintains fleet and legal liability insurance on behalf of the Group and all other Chinese airlines with the People s Insurance Company of China ( PICC ) under the PICC master policy. The Group maintains aviation hull all risks, spares and airline liability insurance, aircraft hull all risks and spare engines deductible insurance, aviation hull war and allied perils policy of the type and in the amount customary in the Chinese aviation industry.

Under Chinese law, civil liability of Chinese airlines for injuries suffered by passengers on domestic flights is limited to RMB70,000 (approximately US$8,455) per passenger. Under the Convention for the Unification of Certain Rules Relating to International Transportation by Air of 1929 (as amended by the protocol of 1955, the Warsaw Convention ), unless a separate agreement has been entered into between China and a specific country, civil liability for injuries suffered by passengers on international flights is limited to US$20,000 per passenger. The Group believes that it maintains adequate insurance coverage for the maximum civil liability that can be imposed in respect of injuries to passengers under Chinese law, the Warsaw Convention or any separate agreement applicable to the Group.

The CAAC allocates insurance premiums payable in respect of the PICC master policy to each participating airline based on the value of the airline s insured aircraft or, in the case of leased aircraft, based on the amount required by the terms of the lease. Insurance claims made by any participating airline may cause the premiums paid by the Group under the PICC master policy to increase. PICC s practice has been to reinsure a substantial portion of its aircraft insurance business through reinsurance brokers on the London reinsurance market.

Intellectual Property

The Group s businesses and operations, other than the businesses and operations of Xiamen Airlines, are conducted under the names China Southern and China Southern Airlines in both English and Chinese. The Group uses as its logo a stylized rendition of a kapok plant. Xiamen Airlines conducts its businesses and operations under the name of Xiamen Airlines in English and Chinese and uses its own logo depicting a stylized rendition of an egret.

The names China Southern and China Southern Airlines contain Chinese words of common usage and are therefore not eligible for registration as tradenames under current Chinese law. The kapok logo is a trademark registered in China and recorded with the International Air Transport Association ( IATA ), the rights to which are owned by CSAHC. The Company and CSAHC have entered into a trademark license agreement (the Trademark License Agreement ), pursuant to which CSAHC has licensed to the Group the right to use the names China Southern and China Southern Airlines in both English and Chinese and granted the Company a 10-year renewable license from 1997 to use the kapok logo on a world-wide basis. CSAHC has retained the right to use the kapok logo in connection with its non-airline related businesses conducted as of the date of the Trademark License Agreement and to permit its affiliates that do not compete, directly or indirectly, with the Group to use the kapok logo. Xiamen Airlines owns all rights to its egret logo, which is a trademark registered in China, and recorded with the IATA.

The Company owns all rights to three trademarks, being SKY PEARL CLUB, the logo relating to Easy Cargo 5000 and SKY PEARL CARD which are registered in China, and recorded with Trademark Office of the State Administration for Industry and Commerce. Zhuhai Airlines Company Limited owns all rights to the airline logo which is registered with the Trademark Office of the State Administration for Industry and Commerce.

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**Organizational Structure**

The following chart illustrates the corporate structure of the Group as of year end 2003 and the aggregate effective equity interest of the Company in each of its principal subsidiaries, affiliated companies and jointly controlled entities.

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The particulars of the Company s principal subsidiaries as of December 31, 2003 are as follows:

| Name of company | Place and date of establishment/operation | Attributable equity interest to the Company | |
|---|---|---|---|
| | | Direct % | Indirect % |
| Guangxi Airlines Company Limited | PRC April 28, 1994 | 60 | |
| Southern Airlines Group Shantou Airlines Company Limited | PRC July 20, 1993 | 60 | |
| Zhuhai Airlines Company Limited | PRC May 8, 1995 | 60 | |
| Xiamen Airlines Company Limited | PRC August 11, 1984 | 60 | |
| Guizhou Airlines Company Limited | PRC November 12, 1991 | 60 | |
| Guangzhou Nanland Air Catering Company Limited | PRC November 21, 1989 | 51 | |
| China Southern West Australian Flying College Pty Ltd. | Australia January 26, 1971 | 65 | |
| China Southern Airlines (Group) Zhuhai Helicopter Company Limited | PRC August 31, 1993 | 100 | |
| Guangzhou Baiyun International Logistic Company Ltd | PRC July 23, 2002 | 61 | |

Affiliated Companies and Jointly Controlled Entities

The particulars of the Group s principal affiliated companies and jointly controlled entity as of December 31, 2003 are as follows:

| Name of company | Place and date of establishment/operation | Attributable equity interest to the company | |
|---|---|---|---|
| | | Direct % | Indirect % |
| Guangzhou Aircraft Maintenance Engineering Company Limited | PRC October 28, 1989 | 50 | |

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| Name of company | Place and date of establishment/operation | Attributable equity interest to the company | |
|---|---|---|---|
| | | Direct % | Indirect % |
| Southern Airlines Group Finance Company Limited | PRC June 28, 1995 | 32 | 15.42 |
| Sichuan Airlines Corporation Limited | PRC August 28, 2002 | 39 | |
| China Postal Airlines Limited | PRC November 25, 1996 | 49 | |
| MTU Maintenance Zhuhai Co. Ltd. | PRC April 6, 2001 | 50 | |
| Zhuhai Xiang Yi Aviation Technology Company Limited | PRC July 10, 2002 | 51 | |

Certain of the Company s subsidiaries, affiliated companies and jointly controlled entities are PRC joint ventures which have limited duration pursuant to PRC law.

**Property, Plant and Equipment**

For a discussion of the Group s aircraft, see Item 4, Information on the Company History and development of the Company -Aircraft Fleet.

The Group s headquarters in Guangzhou occupy an area of approximately 149,000 square meters of land and a total gross floor area of approximately 149,000 square meters. The Group leases from CSAHC the land in Guangzhou on which the Group s headquarters and other facilities are located. The Group also leases from CSAHC certain buildings at the Wuhan, Haikou and Zhengzhou airports.

The Company s principal properties are located at its headquarters site and at its route bases. The following table sets forth certain information with respect to the Company s properties at its headquarters in Guangzhou and certain route bases as of the date hereof.

| | Land (in square meters) | | Buildings (in square meters) | |
|---|---|---|---|---|
| | Owned | Leased | Owned | Leased |
| Guangzhou | | 80,909 | 103,957 | 1,755 |
| Shenzhen | 208,740 | | 35,174 | |
| Zhuhai | 170,062 | | 18,791 | |
| Changsha | 138,949 | | 47,190 | |
| Zhengzhou | 290,841 | | 60,582 | |
| Haikou | 5,265 | | 59,543 | 19,633 |
| Wuhan | | 31,061 | 435 | 26,061 |
| Nanyang | | | 12,156 | |

The following table sets forth certain information with respect to the properties of the Airline Subsidiaries as of the date hereof.

| | Land (in square meters) | | Buildings (in square meters) | |
|---|---|---|---|---|
| | Owned | Leased | Owned | Leased |
| Xiamen | 211,632 | | 29,292 | 1,564 |
| Shantou | 20,292 | | 27,810 | 3,127 |

| | | | |
|---|---|---|---|
| Zhuhai | 53,797 | 29,697 | 1,513 |
| Guilin | | 14,594 | 349 |

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| | Land (in square meters) | | Buildings (in square meters) | |
|---|---|---|---|---|
| | **Owned** | **Leased** | **Owned** | **Leased** |
| Guizhou | 270,001 | | 10,466 | |

As systems for registration and transfer of land use rights and related real property interests in China have been implemented relatively recently, such systems do not yet comprehensively account for all land and related property interests. The land in Guangzhou on which the Group s headquarters and other facilities are located and the buildings that the Group 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 may not be registered with the relevant authorities. Lack of registration may affect the validity of such lease agreements. There are certain other parcels of land and buildings owned or used by the Group that lack adequate documentation. Lack of adequate documentation for land use rights and ownership of buildings may impair the ability of the Group to dispose of or mortgage such land use rights and buildings.

The Group 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. The Group understands that the CAAC is basing its conclusion on an agreement among certain governmental authorities relating to such land. CSAHC has agreed to indemnify the Group against any loss or damage caused by any challenge of, or interference with, the use by the Group of any of their respective land and buildings.

## ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS.

The following discussion and analysis should be read in conjunction with the Financial Statements of the Group contained elsewhere in this Annual Report. The Group maintains its books and accounts in accordance with PRC Accounting Rules and Regulations ( PRC GAAP ) and prepares its financial statements in accordance with both PRC GAAP and IFRS. The Financial Statements contained elsewhere in this Annual Report have been prepared in accordance with IFRS. IFRS differs in certain significant respects from U.S. GAAP. Information relating to the nature and effect of such differences is presented in Note 33 to the Financial Statements.

### Critical Accounting Policies

The discussion and analysis of the Group s financial condition and results of operations are based upon the consolidated financial statements, which have been prepared in accordance with IFRS. The preparation of such consolidated financial statements requires the Group to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. The Group believes that its critical accounting policies are limited to those described below. For a detailed discussion on the application of these and other accounting policies, see Note 2 to the Financial Statements.

Revenue Recognition

The Group records sales of passenger, cargo and mail tickets as Sales in advance of carriage , a current liability, on the consolidated balance sheet. Passenger, cargo and mail revenues are recognized and the related current liability is reduced when the transportation is provided. Sales in advance of carriage therefore represents ticket sold for future travel dates and estimated future refunds and exchanges of tickets sold for past travel dates. The Group s balance of sales in advance of carriage as of December 31, 2003 was RMB466 million.

Estimating the amount of tickets that will be refunded, exchanged, or expired involves some level of subjectivity and judgment. According to the relevant rules in the PRC in relation to air transportation, the valid period for tickets sold is up to a year from the date of sale. Sales in advance of carriage, therefore, includes an estimate of the amount of future refunds and exchanges, and expired tickets. These estimates are based on historical experience over many years. The Group and members of the airline industry have consistently applied this accounting method to estimate revenue from expired tickets. Estimated future refunds and exchanges included in sales in advance of carriage account are constantly evaluated based on subsequent refund and exchange activity to validate the accuracy of the Group s estimates with respect to expired tickets.

Events and circumstances outside of historical fare sale activity or historical customer travel patterns, as noted above, can result in actual refunds, exchanges, or expired tickets differing significantly from estimates. The Group evaluates its estimates within a narrow range of acceptable amounts. If actual refunds, exchanges, or expiry experience results in an amount outside of this range, estimates and assumptions are reviewed and adjustments to Sales in advance of carriage and to Passenger revenue are recorded as necessary. The Group s estimation techniques have been consistently applied from year to year; however, as with any estimates, actual refund and exchange activity may vary from estimated amounts. Furthermore, the Group believes it is unlikely that materially different estimates for future refunds, exchanges, and forfeited tickets would be reported based on other reasonable assumptions or conditions suggested by actual historical experience and other data available at the time estimates were made.

Up to date, the Group has not experienced any material fluctuations in estimated refunds and exchanges, and correspondingly, expired tickets, due to many of the factors described above.

Fixed assets

The Group have approximately RMB28,536 million fixed assets as of December 31, 2003. In addition to the original cost of these assets, their recorded value is impacted by a number of policy elections, including the estimation of useful lives and residual values and when necessary, impairment charges.

The Group records aircraft at acquisition cost. Depreciable life is determined through economic analysis, reviewing existing fleet plans, recommendations from manufacturers and comparing estimated lives to other airlines that operate similar fleets. Residual values are estimated based on our historical experience with regards to the sale of aircraft and are established in conjunction with the estimated useful lives of the aircraft. Residual values are based on current dollars when the aircraft are acquired and typically reflect asset values that have not reached the end of their physical life. Both depreciable lives and residual values are reviewed periodically to recognize changes in our fleet plan and changes in conditions.

In addition, the Group evaluates fixed assets used in operations for impairment. If circumstances indicate that the net book value of an asset may not be recoverable, this asset may be considered impaired , and an impairment loss may be recognized in accordance with IAS 36 Impairment of Assets . The amount of impairment loss is the difference between the carrying amount of the asset and its recoverable amount. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, the Group utilizes certain assumptions, including, but not limited to: (i) estimated fair market value of the assets, and (ii) estimated future cash flows expected to be generated by these assets, which are based on additional assumptions such as asset utilization, length of service the asset will be used in the Group s operations and estimated residual values. The Group will use all readily available information in determining an amount that is a reasonable approximation of recoverable amounts, including estimates based on industry trends and reference to market rates and transactions. Changes to the above estimates may have a material effect on the Group s Financial Statements. As of December 31, 2003, based on the result of evaluation, the

Group considered that no impairment is required.

**Overview**

In 2003, the Group encountered the most unprecedented challenges and difficulties. The outbreak of the Severe Acute Respiratory Syndrome ( SARS ) earlier 2003 severely hit the PRC aviation industry. From April to June 2003, the Group s passenger volume and passenger load factor dropped which caused the revenue passenger kilometers ( RPK ) for April, May and June of 2003 to fall by 40%, 83.5% and 61.5% respectively, as compared to same period in 2002. In order to minimize the negative impact of SARS, the Group implemented various measures to adjust its operating capacity, for example by reducing the number of flights and suspending certain routes, in response to the reduced air traffic demand caused by the negative impact of SARS. The SARS was effectively under control in the PRC in July 2003 and the domestic market started to recover in the third quarter of 2003. The Group gradually resumed all its suspended flights since July 2003.

In order to alleviate the financial pressure suffered by the PRC civil aviation industry as a result of the SARS epidemic, the PRC government waived the levies of the CAAC Infrastructure Development Fund, sales tax and related supplementary taxes on passenger revenue payable by the PRC airlines, during the period from May 1, 2003 to December 31, 2003.

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In addition, the political tension in the Middle East, in particular the Iraq war in March 2003, led to a surge in oil prices which in turn caused an increase in the Group s jet fuel cost.

The Group conducts a portion of its airline operations through the Airline Subsidiaries. Operating results for the Airline Subsidiaries are included in each of the years presented in the Financial Statements. The Airline Subsidiaries, which derive substantially all of their operating revenue from passenger traffic, accounted for 26.8% and 30.7% of the Group s total operating revenue, and 34.5% and 37.2% of the Group s total passengers carried, in 2002 and 2003, respectively. Xiamen Airlines is the largest member of the Airline Subsidiaries, with operating revenue of RMB3,278 million and RMB3,460 million in 2002 and 2003, respectively, or 18.2% and 19.8% of the Group s total operating revenue.

The Group s operating revenue is substantially dependent on the passenger and cargo traffic volume carried, which is subject to seasonal and other changes in traffic patterns, the availability of appropriate time slots for the Group s flights and alternative routes, the degree of competition from other airlines and alternate means of transportation, as well as other factors that may influence passenger travel demand and cargo and mail volume. In particular, the Group s airline revenue is generally higher in the second and third quarters than in the first and fourth quarters.

Like most airlines, the Group is subject to a high degree of financial and operating leverage. A significant percentage of the Group s operating expenses is fixed costs that do not vary proportionally based on the Group s yields or the load factors. These fixed costs include depreciation expense, jet fuel costs, landing and navigation fees, financing costs, operating lease payments, aircraft maintenance costs and labor for flight crew, cabin crew and ground personnel. Thus, a minor change in the Group s yields or load factors would have a material effect on the Group s results of operations. In addition, certain of these expenses, primarily financing costs and operating lease payments, labor costs and depreciation do not vary based on the number of flights flown. Thus, the Group s operating results can also be substantially affected by minor changes in aircraft utilization rates. The Group is and will continue to be highly leveraged with substantial obligations denominated in foreign currencies and, accordingly, the results of its operations are significantly affected by fluctuations in foreign exchange rates, particularly for the U.S. dollar and the Japanese yen. The Group recognized a net exchange loss of RMB175 million and RMB164 million in 2002 and 2003, respectively. These amounts represente