

CHINA EASTERN AIRLINES CORP LTD

Form 20-F

July 07, 2006

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As filed with Securities and Exchange Commission on July 7, 2006

**SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549**

FORM 20-F

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

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2005
OR**

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

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

Commission file number 1-14550

(Exact Name of Registrant as Specified in Its Charter)

China Eastern Airlines Corporation Limited
(Translation of Registrant's Name Into English)

The People's Republic of China
(Jurisdiction of Incorporation or Organization)

2550 Hong Qiao Road
Hong Qiao International Airport
Shanghai 200335
The People's Republic of China
(8621) 6268-6268

(Address and Telephone Number 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
American Depositary Shares Ordinary H Shares, par value RMB1.00 per share	The New York Stock Exchange The New York Stock Exchange*

* Not for trading, but only in connection with the registration of American Depositary Shares. The Ordinary H Shares are also listed and traded on The Stock Exchange of Hong Kong Limited.

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

None

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

(Title of Class)

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.

As of December 31, 2005, 3,300,000,000 Ordinary Domestic Shares, par value RMB1.00 per share, were issued and outstanding, and 1,566,950,000 Ordinary H Shares par value RMB1.00 per share, were issued and outstanding. H Shares are Ordinary Shares of the Company listed on The Stock Exchange of Hong Kong Limited.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes No

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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17 Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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SUPPLEMENTAL INFORMATION AND EXCHANGE RATES

In this annual report, unless otherwise specified, the term dollars , U.S. dollars or US\$ refers to United States dollars, the legal tender currency of the United States of America, or the United States or the U.S.; the term Renminbi or RMB refers to Renminbi, the legal tender currency of The People's Republic of China, or China or the PRC; and the term Hong Kong dollars or HK\$ refers to Hong Kong dollars, the legal tender currency of the Hong Kong Special Administrative Region of China, or Hong Kong.

In this annual report, the term we , us , our , our company or China Eastern refers to China Eastern Airlines Corporation Limited, a joint stock limited company incorporated under the laws of the PRC on April 14, 1995, and, unless the context otherwise requires, its subsidiaries, or, in respect of references to any time prior to the incorporation of China Eastern Airlines Corporation Limited, the core airline business carried on by its predecessor, China Eastern Airlines, which was assumed by China Eastern Airlines Corporation Limited pursuant to the restructuring described in this annual report. The term CEA Holding refers our parent, China Eastern Air Holding Company, which was established on October 11, 2002 as a result of the merger of our former controlling shareholder, Eastern Air Group Company, or EA Group, with China Northwest Airlines Company and Yunnan Airlines Company.

For purpose of this annual report, references to The People's Republic of China, China and the PRC do not include Hong Kong, the Macau Special Administrative Region of China, or Macau, or Taiwan.

CAUTIONARY STATEMENT WITH RESPECT TO FORWARD-LOOKING STATEMENTS

This annual report contains certain forward-looking statements that are, by their nature, subject to significant risks and uncertainties. These forward-looking statements include, without limitation, statements relating to:

our fleet development plans, including, without limitation, related financing, schedule, intended use and planned disposition;

the planned expansion of our cargo operations;

the impact of changes in the policies of the Civil Aviation Administration of China, or the CAAC, regarding route rights;

the impact of the CAAC policies regarding the restructuring of the airline industry in China;

our expansion plans, including acquisition of other airlines;

our marketing plans, including the establishment of additional sales offices;

our plan to add new pilots; and

the impact of unusual events on our business and operations.

The words anticipate , plan , believe , estimate , expect , intend and similar expressions, as they relate to our or its management, are intended to identify some of these forward-looking statements. These forward-looking statements reflect our current view with respect to future events. Actual events or results may differ materially from information contained in these forward-looking statements as a result of a number of factors, including, without limitation:

any changes in regulatory policies of the CAAC;

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the effects of competition on the demand for and price of our services;

the availability of qualified flight personnel and airport facilities;

any significant depreciation of Renminbi or Hong Kong dollars against U.S. dollars, Japanese yen or Euro, the currencies in which the majority of our borrowings are denominated;

the availability and cost of the aviation fuel;

changes in political, economic, legal and social conditions in China;

the fluctuation of interest rates;

our ability to obtain adequate financing, including any required external debt and acceptable bank guarantees;
and

general economic conditions in markets where our company operates.

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GLOSSARY OF TECHNICAL TERMS

Capacity measurements

ATK (available tonne kilometers) the number of tonnes of capacity available for the carriage of revenue load (passengers and cargo) multiplied by the distance flown

ASK (available seat kilometers) the number of seats made available for sale multiplied by the distance flown

AFTK (available freight tonne-kilometers) the number of tonnes of capacity available for the carriage of cargo and mail multiplied by the distance flown

Traffic measurements

revenue passenger-kilometers or RPK the number of passengers carried multiplied by the distance flown

revenue freight tonne-kilometers or RFTK cargo and mail load in tonnes multiplied by the distance flown

revenue passenger tonne-kilometers or RPTK passenger load in tonnes multiplied by the distance flown

revenue tonne-kilometers or RTK load (passenger and cargo) in tonnes multiplied by the distance flown

Load factors

overall load factor tonne-kilometers expressed as a percentage of ATK

passenger load factor passenger-kilometers expressed as a percentage of ASK

break-even load factor the load factor required to equate traffic revenue with our operating costs assuming that our total operating surplus is attributable to scheduled traffic operations

Yield and cost measurements

passenger yield (revenue per passenger-kilometer) revenue from passenger operations divided by passenger-kilometers

cargo yield (revenue per cargo tonne-kilometer) revenue from cargo operations divided by cargo tonne-kilometers

average yield (revenue per total tonne-kilometer) revenue from airline operations divided by tonne-kilometers

unit cost operating expenses divided by ATK

tonne a metric ton, equivalent to 2,204.6 lbs

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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.

A. Selected Financial Data

The selected financial data of the consolidated statements of operations for the years ended December 31, 2001, 2002, 2003, 2004 and 2005 and the selected financial data of the balance sheets as of December 31, 2001, 2002, 2003, 2004 and 2005 have been derived from our audited consolidated financial statements, which have been prepared in accordance with the International Financial Reporting Standards, or IFRS, and audited by PricewaterhouseCoopers, an independent registered public accounting firm in Hong Kong. PricewaterhouseCoopers reports in respect of the consolidated statements of operations for the years ended December 31, 2003, 2004 and 2005 and the consolidated balance sheets as of December 31, 2004 and 2005 and the related footnotes are included in this annual report. PricewaterhouseCoopers reports in respect of the consolidated statements of operations for the years ended December 31, 2001 and 2002 and the consolidated balance sheets as of December 31, 2001, 2002 and 2003 and the related footnotes are not included in this annual report.

As required under IFRS, the acquisition accounting method was applied to account for our acquisitions of certain assets and liabilities relating to the aviation businesses of CEA Northwest (as defined below) and CEA Yunnan (as defined below) in 2005, as described in Item 4. Information on the Company The History and Development of the Company , such that as of June 30, 2005, only the acquired assets and liabilities were included in the consolidated financial statements. The results of the acquired operations and their related cash flows were included in the consolidated financial statements of the Company beginning July 1, 2005. In contrast, under the generally accepted accounting principles in the United States, or U.S. GAAP, such transactions are considered to be combination of entities under common control since we and the aviation businesses of CEA Northwest and CEA Yunnan were under the common control of CEA Holding. Such transactions were accounted for in a manner similar to pooling-of-interests , retroactively restating all years presented on a combined basis as if the acquisitions had been in effect since inception, whereby related assets and liabilities of the acquired aviation businesses would be accounted for at historical cost and the related results of operations would be included in the consolidated financial statements from the earliest year presented. For a summary of significant differences between IFRS and U.S. GAAP as they relate to us and the effects of such differences on net profit (loss) attributable to equity holders and net assets for all years presented, see Note 43 to our audited consolidated financial statements included in this annual report. Our condensed consolidated financial statements prepared and presented in accordance with U.S. GAAP to reflect the effect of the acquisitions of CEA Northwest s and CEA Yunnan s aviation businesses under common control for the relevant periods are set forth in Note 44 to our audited consolidated financial statements included in this annual report.

We omitted the selected U.S. GAAP selected financial data as of, and for the year ended December 31, 2001 because no reliable financial information as of, and for the year ended December 31, 2001 with respect to the acquired aviation businesses of CEA Yunnan and CEA Northwest can be produced without unreasonable expenses or efforts.

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The following information should be read in conjunction with, and is qualified in its entirety by our audited consolidated financial statements included in this annual report.

	Year Ended December 31,					2005
	(Restated except for the year ended December 31, 2005)					
2001	2002	2003	2004	2005		
RMB	RMB	RMB	RMB	RMB	US\$	
(in millions, except per share or per ADS data)						
Income Statement Data:						
IFRS: ⁽¹⁾⁽²⁾						
Revenues	12,301	13,332	14,470	21,386	27,454	3,402
Other operating income	55	63	50	85	245	30
Operating expenses	(11,341)	(12,350)	(14,454)	(20,239)	(27,685)	(3,431)
Operating profit	1,015	1,045	66	1,232	14	2
Finance costs, net	(688)	(777)	(775)	(641)	(578)	(72)
Profit (loss) before income tax	330	235	(741)	586	(577)	(72)
Profit (loss) for the year attributable to equity holders of the Company	557	64	(1,097)	321	(467)	(58)
Basic and fully diluted earnings (loss) per share ⁽³⁾	0.11	0.01	(0.23)	0.07	(0.10)	(0.01)
Basic and fully diluted earnings (loss) per ADS	11.50	1.31	(22.54)	6.59	(9.60)	(1.19)
U.S. GAAP: ⁽⁴⁾						
Profit (loss) attributable to equity holders		(365)	(1,391)	459	(1,383)	(171)
Basic and fully diluted earnings (loss) per share ⁽³⁾		(0.08)	(0.29)	0.09	(0.28)	(0.04)
Basic and fully diluted earnings (loss) per ADS		(7.51)	(28.59)	9.43	(28.42)	(3.52)

	As of December 31,					2005
	(Restated except for data as of December 31, 2005)					
2001	2002	2003	2004	2005		
RMB	RMB	RMB	RMB	RMB	US\$	
(in millions)						
Balance Sheet Data:						
IFRS: ⁽⁵⁾						
Cash and cash equivalents	1,331	1,945	1,583	2,114	1,864	231
Net current liabilities	(3,232)	(7,504)	(9,982)	(12,491)	(25,598)	(3,172)
Non-current assets	25,299	28,147	33,039	36,812	53,305	6,605
Long term borrowing, including current portion	5,301	6,495	11,223	10,736	12,659	1,569
	9,871	8,184	7,101	8,662	10,608	1,314

Obligations under finance lease, including current portion						
Total share capital and reserves	7,282	7,319	6,175	6,481	6,096	755
U.S. GAAP: ⁽⁴⁾						
Total assets		45,462	50,598	53,487	59,218	7,338
Owner s equity		5,934	4,543	5,028	6,100	750

(1) Certain incomes and expenses for the years ended December 31, 2001, 2002, 2003 and 2004 have been reclassified under the IFRS. Such reclassifications have no effect on the profit (loss) attributable to equity holders for each of those affected years.

(2) Certain expenses for the years ended December 31, 2001, 2002, 2003 and 2004 have been restated as a result of the retrospective application of changes to our accounting policy relating to the costs of overhaul of owned and finance leased aircraft and engines. Such adjustments resulted in a 2.8% increase in

the profit attributable to equity holders for the year ended December 31, 2001, a 25.6% decrease in the profit attributable to equity holders for the year ended December 31, 2002, a 15.5% increase in the loss attributable to equity holders for the year ended December 31, 2003 and a 37.5% decrease in the profit attributable to equity holders for the year ended December 31, 2004 . See Note 2(a) to our audited consolidated financial statements included in this annual report.

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- (3) The calculation of earnings (loss) per share is based on the consolidated profit (loss) attributable to equity holders and 4,866,950,000 shares in issue.

- (4) Selected U.S. GAAP financial data for the years ended December 31, 2002, 2003 and 2004 have been restated to reflect our acquisitions of the assets and liabilities relating to the aviation businesses of CEA Northwest and CEA Yunnan in 2005. See Note 44 to our audited consolidated financial statements included in this annual report.

- (5) Selected balance sheet data for the years ended December 31, 2001, 2002, 2003 and 2004 have been restated as a result of the retrospective application of

changes to our accounting policy relating to the costs of overhaul of owned and finance leased aircraft and engines. See Note 2(a) to our audited consolidated financial statements included in this annual report.

Exchange Rate Information

This annual report contains translations of certain amounts into U.S. dollars solely for your convenience. Except where otherwise specified, translations of amounts from Renminbi to U.S. dollars have been made at the noon buying rate, or the Noon Buying Rate, in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York on December 31, 2005 of US\$1.00 = RMB8.0702. You should not construe the translations as representations that the Renminbi amounts could have been, or could be, converted into U.S. dollars at that rate or at any other rate.

The noon buying rate in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York was RMB7.9943 = US\$1.00, on June 30, 2006. The following tables set forth certain information concerning exchange rates between Renminbi and U.S. dollars for the periods indicated:

Period	Average ⁽¹⁾ Noon Buying Rate ⁽²⁾ (RMB per US\$)	Noon Buying Rate (RMB per US\$)		
		Period	High	Low
2005	8.1826	January 2006	8.0596	8.0702
2004	8.2768	February 2006	8.0616	8.0415
2003	8.2771	March 2006	8.0505	8.0167
2002	8.2772	April 2006	8.0248	8.0040
2001	8.2772	May 2006	8.0300	8.0005
		June 2006	8.0225	7.9943

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

(2) Noon Buying Rate in New York City for cable transfers payable in foreign

currencies as certified for customs purpose by the Federal Reserve Bank of New York.

Selected Operating Data

The following table sets forth certain operating data of our company for the five years ended December 31, 2005, which have been derived from financial information prepared in accordance with IFRS and other data provided by us and are not audited. All references in this annual report to our cargo operations, cargo statistics or cargo revenues include figures for cargo and mail.

	Year Ended December 31,				
	2001	2002	2003	2004	2005
Selected Airline Operating Data:					
Capacity:					
ATK (millions)	4,188.2	4,366.6	4,774.5	7,071.2	8,751.5
ASK (millions)	25,813.5	27,962.5	29,780.0	41,599.1	52,427.9
AFTK (millions)	1,865.0	1,850.0	2,094.3	3,327.3	4,033.0
Traffic:					
Revenue passenger-kilometers (millions)	15,911.4	18,206.4	18,002.7	27,580.8	36,380.6
Revenue tonne-kilometers (millions)	2,373.2	2,652.2	2,907.7	4,340.7	5,395.2
Revenue passenger tonne-kilometers (millions)	1,423.4	1,629.2	1,611.1	2,466.0	3,273.7
Revenue freight tonne-kilometers (millions)	949.8	1,023.0	1,296.6	1,874.7	2,151.5
Kilometers flown (millions)	147.2	158.8	176.5	242.8	287.7
Hours flown (thousands)	220.4	234.6	259.4	360.4	467.8
Number of passengers carried (thousands)	10,371.4	11,533.1	12,040.2	17,711.0	24,290.5
Weight of cargo carried (millions of kilograms)	302.0	344.7	459.8	663.6	775.5

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	Year Ended December 31,				
	2001	2002	2003	2004	2005
Average distance flown (kilometers per passenger)	1,534.2	1,578.6	1,495.2	1,557.3	1,497.7
Load Factor:					
Overall load factor (%)	56.7	60.7	60.9	61.4	61.7
Passenger load factor (%)	61.6	65.1	60.5	66.3	69.4
Break-even load factor (based on ATK) (%)	54.7	59.9	63.6	62.2	66.0
Yield and Cost Statistics (RMB):					
Passenger yield (passenger revenue/passenger-kilometers)	0.60	0.55	0.57	0.56	0.57
Cargo yield (cargo revenue/cargo tonne-kilometers)	2.20	2.39	2.46	2.36	2.31
Average yield (passenger and cargo revenue/ tonne-kilometers)	4.92	4.71	4.62	4.60	4.79
Unit cost (operating expenses/ATK)	2.69	2.87	2.94	2.86	3.16

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

An investment in our company involves a number of risks, some of which may be special or significantly different from risks that are normally associated with an investment in a U.S. company. You should carefully consider the following information about the risks in investing in our company, along with the other information presented in this annual report.

Fuel supply and costs

The availability and costs of the aviation fuel has a significant impact on our financial condition and results of operations. In the past, jet fuel shortages have occurred in China and, on limited occasions, required us to delay or cancel flights. Although jet fuel shortages have not occurred since the end of 1993, we cannot assure you that jet fuel shortages will not occur in the future. Fuel prices continue to be susceptible to, among other factors, political unrest in various parts of the world, Organization of Petroleum Exporting Countries policy, the rapid growth of economies in China and India, the levels of inventory carried by industries, the amounts of reserves built by governments, disruptions to production and refining facilities and weather. These and other factors that impact the global supply and demand for aircraft fuel may affect our financial performance due to its sensitivity to fuel prices. Our financial performance may be especially susceptible to recent trends of escalating fuel prices worldwide. Between May 31, 2005 and May 31, 2006, the official domestic fuel price in China increased by 19.9%. This increase is consistent with other incidents of rising fuel prices that we have seen during the past few years, and there can be no assurance that fuel prices will remain constant or decline in the future.

Fuel costs constitute a significant portion of our operating costs and, in 2005, accounted for approximately 32.1% of our operating expenses. Between 2004 and 2005, our expenses for fuel rose by 63.7%, partially as a result of increased weighted average domestic and international fuel prices, and partially as a result of the expansion of our fleet. Between 2004 and 2005, the weighted average domestic and international fuel prices that we paid increased by approximately 24.5% and 39.8%, respectively. Due to the highly competitive nature of the airline industry and government regulation on airfare pricing, we may be unable to fully or effectively pass on to our customers any increased fuel costs we may encounter in the future. Any jet fuel shortages or any increase in domestic or international jet fuel price may materially and adversely affect our financial condition and results of operations. From time to time, we may hedge some of our future fuel purchases to protect against potential spikes in price. However, these hedging

strategies may not always be effective and can result in losses depending on price changes.

Competition

We face intense competition in each of the domestic, Hong Kong regional and international markets that we serve. In our domestic markets, we compete against smaller domestic airline companies that operate with costs that are lower than ours. We also increasingly face competition from entrants to our domestic markets, as new investments into China's civil aviation industry are made following the CAAC's relaxation of certain private-sector investment rules in July 2005. See the section headed "Item 4. Information on the Company Business Overview Competition" for more details. In our Hong Kong regional and international markets, we compete against international airline companies that have significantly longer operating history, greater name recognition, more resources or larger sales networks than our company, or participate in reservation systems that are more convenient than ours. The public's perception of the safety records of Chinese airlines also materially and adversely affects our ability to compete against our international competitors. In response to competition, we have, from time to time in the past, lowered our airfares for certain of our routes, and we may be required to do the same in the future. Increased competition and pricing pressures from competition may have a material adverse effect on our financial condition and results of operations.

Government regulation

The Chinese civil aviation industry is subject to a high degree of regulation by the CAAC. Regulatory policies issued or implemented by the CAAC encompass virtually every aspect of airline operations, including, among other things:

route allocation;

pricing of domestic airfare;

the administration of air traffic control systems and certain airports; and

aircraft registration and aircraft airworthiness certification.

As a result, we may face significant constraints on our flexibility and ability to expand our business operations or to maximize our profitability.

Government ownership and control of our company

Most of the major airline companies in China are currently majority owned either by the central government of China or by provincial or municipal governments in China. CEA Holding currently holds approximately 61.64% of our company's equity interests on behalf of the Chinese government. As a result, CEA Holding will be able to elect our entire board of directors and otherwise be able to control us. CEA Holding will also have sufficient voting control to effect transactions without the concurrence of our minority shareholders. The interests of the Chinese government as the ultimate controlling person of our company and most of other major Chinese airlines could conflict with the interests of our minority shareholders. Although

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the CAAC currently has a policy of equal treatment for all Chinese airlines, we cannot assure you that the CAAC will not favor other Chinese airlines over our company.

Insurance coverage and cost

As a result of the events of September 11, 2001, aviation insurers have significantly reduced the maximum amount of insurance coverage available to commercial air carriers for liability to persons other than employees or passengers for claims resulting from acts of terrorism, war or similar events, or war-risk coverage. At the same time, they have significantly increased the premiums for such coverage, as well as for aviation insurance in general. Also, Our company has further extended our insurance coverage purchased prior to the September 11 events to November 30, 2006. However, if the insurance carriers reduce further the amount of insurance coverage available or increase the premium for such coverage when we renew our insurance coverage, our financial condition and results of operations may be materially and adversely affected.

Direct air link between China's mainland and Taiwan

Currently, our operations on the Hong Kong regional routes benefit from traffic between Hong Kong and mainland China ultimately originating in Taiwan. During the Lunar Chinese New Year peak travel season in 2003, from late-January to mid-February, the Chinese government allowed special chartered flights between Shanghai and Taiwan for the first time. During the Lunar Chinese New Year peak travel seasons in 2005 and 2006, from late-January to mid-February, airlines from both mainland China and Taiwan (including our company) operated 48 and 72, respectively, non-stop direct chartered flights between selected cities of mainland China and Taiwan. Although regular direct flights between Taiwan and mainland China are still not permitted, our Hong Kong regional routes may be materially and adversely affected if such regular direct flights are permitted in the future. We cannot assure you that we will obtain sufficient Taiwan-mainland China routes, or that the yields on these routes will be adequate, to offset any material adverse effect on our revenues derived from our Hong Kong regional routes.

Chinese aviation infrastructure limitations and safety

The rapid increase in air traffic volume in China in recent years has put pressure on many components of the Chinese airline industry, including air traffic control systems, the availability of qualified flight personnel and airport facilities. Our ability to provide safe air transportation depends on the availability of qualified and experienced pilots in China and the improvement of maintenance services, national air traffic

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control and navigational systems and ground control operations at Chinese airports. If any of these is not available or is inadequate, our ability to provide safe air transportation will be compromised and our financial condition and results of operations may be materially and adversely affected.

Operating leverage

The airline industry is characterized by a high degree of operating leverage. Due to high fixed costs, including payments made in connection with aircraft leases, the expenses relating to the operation of any given flight do not vary proportionately with the number of passengers carried, while revenues generated from a particular flight are directly related to the number of passengers carried and the fare structure of the flight. Accordingly, a decrease in revenues may result in a proportionately higher decrease in profits.

Liquidity

We have substantial debts, and will continue to have substantial debts in the future. In addition, we have recently entered into contractual commitments to acquire a number of new aircraft for delivery over the next few years. See the section headed "Item 4. Information on the Company Description of Property Fleet". As of December 31, 2005, our total outstanding debt was RMB52,403 million, and our long-term debt to equity ratio was 3.4. As of the same date, our current liabilities exceeded our current assets by RMB25,598 million. Short-term bank loans outstanding totaled RMB13,711 million as of December 31, 2005.

We largely rely on cash flow generated from our operations and external financing (including short-term bank loans) to meet our debt repayment obligations and working capital requirements. If our

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operating cash flow is materially and adversely affected by factors such as increased competition, significant decrease in demand for our services, or significant increase in jet fuel price, our liquidity would be materially and adversely affected. We have arranged financing with domestic and foreign-funded banks in China as necessary to meet our working capital requirements. We have also tried to ensure our liquidity by structuring a substantial portion of our short-term bank loans to be rolled over upon maturity. These efforts, however, may ultimately prove insufficient. Our ability to obtain financing may be affected by our financial position and leverage and our credit rating, as well as by prevailing economic conditions and the cost of financing in general. If we are unable to obtain adequate financing for our capital requirements, our liquidity and operations would be materially and adversely affected.

Future financing requirements

We require significant amounts of external financing to meet our capital commitments for adding and upgrading aircraft and flight equipment and for other business expansion needs. In the past, we have obtained, sometimes with the assistance of the CAAC, guarantees from Bank of China and other Chinese banks in respect of payments under our foreign loan and capital lease obligations. However, we cannot assure you that we will be able to continue to obtain bank guarantees in the future. The unavailability of guarantees from Bank of China or other acceptable banks or the increased cost of such guarantees may materially and adversely affect our ability to borrow internationally or enter into international aircraft lease financings on acceptable terms. The ability of our company to obtain financing may also be affected by our financial position and leverage and our credit rating as well as by prevailing economic conditions and the cost of financing generally. If we were unable to obtain financing for a significant portion of our capital requirements, our ability to acquire new aircraft or expand our operations may be impaired. We have and in the future will likely continue to have substantial debts. As a result, the interest cost associated with these debts might impair our future profitability and cause our earnings to be subject to a higher degree of volatility.

Related party transactions; conflict of interests

We have engaged in, from time to time, and may continue to engage in, in the future, a variety of transactions with CEA Holding and its various members, from whom we receive a number of important services, including support for in-flight catering and assistance with importation of aircraft, flight equipment and spare parts. Our transactions with CEA Holding and its members are conducted through a series of arm's length contracts, which we have entered into with CEA Holding and its members in the ordinary course of business. However, because we are controlled by CEA Holding and CEA Holding may have interests that are different from our interests, we cannot assure you that CEA Holding will not take actions that will serve its interests or the interests of its members over our interests.

Acquisitions

We may expand our business through acquisition of airline companies or airline-related businesses. Such acquisitions involve uncertainties and risks, including the following:

difficulty with integrating the assets and operations of the acquired airline companies or airline-related businesses, including their employees, corporate cultures, managerial systems, processes and procedures and management information systems and services;

failure to achieve the anticipated synergies, cost savings or revenue-enhancing opportunities resulting from the acquisition of such airline companies or airline-related businesses;

difficulty with exercising control and supervision over the newly acquired operations; and

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increased financial pressure resulting from the assumption of recorded and unrecorded liabilities of the acquired airline companies or airline-related businesses.

If we are unable to manage or integrate the newly acquired airlines or airline-related businesses successfully without substantial expense, delay or other operational or financial problems, we may be unable to achieve the objectives or anticipated synergies of such acquisitions and such acquisitions may adversely impact the operations and financial results of our existing businesses.

Limitation on foreign ownership

The current CAAC policies limit foreign ownership in Chinese airlines. Under these limits, non-Chinese residents and Hong Kong, Macau or Taiwan residents cannot hold majority equity interest in a Chinese airline company. At present, approximately 32.2% of our total outstanding shares are held by non-Chinese residents and Hong Kong, Macau or Taiwan residents (excluding the qualified foreign institutional investors that are approved to invest in the A-share market of the PRC). As a result, our access to international equity capital markets may be limited. This restriction may also limit the opportunities available to our company to obtain funding or other benefits through the creation of equity-based strategic alliances with foreign carriers. We cannot assure you that the CAAC will increase these limits in the near future or at all.

Adverse public health epidemics or pandemics

Adverse public health epidemics or pandemics could disrupt businesses and the national economy of China and other countries where we do business. From December 2002 to June 2003, China and other countries experienced an outbreak of a new and highly contagious form of atypical pneumonia now known as severe acute respiratory syndrome, or SARS. On July 5, 2003, the World Health Organization declared that the SARS outbreak had been contained. However, a number of isolated new cases of SARS were subsequently reported, most recently in c