SEMICONDUCTOR MANUFACTURING INTERNATIONAL CORP
Form 20-F
June 29, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 20-F

(Mark One)

¨ **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, 2005

OR

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

¨ **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Date of event requiring this shell company report _____

Commission file number 1-31994

Semiconductor Manufacturing International Corporation

(Exact name of Registrant as specified in its charter)

Cayman Islands

(Jurisdiction of incorporation or organization)

18 Zhangjiang Road, Pudong New Area, Shanghai, China 201203

(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 Shares, par value US$0.0004	**The Stock Exchange of Hong Kong Limited***
American Depositary Shares	**The New York Stock Exchange, Inc.**

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 ordinary shares as of the close of the period covered by the annual report.

As of December 31, 2005, there were 18,301,680,867 ordinary shares, par value US$0.0004 per share, outstanding, of which 889,517,900 ordinary shares were held in the form of 17,790,358 ADSs. Each ADS represents 50 ordinary shares.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x 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 x

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 ¨

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 Securities Exchange Act of 1934. (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

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 Securities Exchange Act of 1934). Yes ¨ No x

* Not for trading, but only in connection with the listing of American Depositary Shares on the New York Stock Exchange, Inc.

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CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This annual report may contain, in addition to historical information, forward-looking statements within the meaning of the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Examples of these forward-looking statements include, without limitation: statements related to our business strategy; our outlook for 2006; our capacity utilization rate, production capacity and production capacity mix; our 2006 planned capital expenditures, research and development expenditures, depreciation and amortization and wafer capacity; and our sources of liquidity, cash flow, funding needs and financing. These forward-looking statements are based on SMIC s current assumptions, expectations and projections about future events. SMIC uses words like believe, anticipate, intend, estimate, expect, project similar expressions to identify forward-looking statements, although not all forward-looking statements contain these words. These forward-looking statements are necessarily estimates reflecting the best judgment of SMIC s senior management and involve significant risks, both known and unknown, uncertainties and other factors that may cause SMIC s actual performance, financial condition or results of operations to be materially different from those suggested by the forward-looking statements including, among others, risks associated with cyclicality and market conditions in the semiconductor industry, intense competition, timely wafer acceptance by SMIC s customers, timely introduction of new technologies, SMIC s ability to ramp new products into volume, supply and demand for semiconductor foundry services, industry overcapacity, shortages in equipment, components and raw materials, availability of manufacturing capacity and financial stability in end markets. In addition to the foregoing factors, a description of certain other risks and uncertainties which may cause actual results to differ materially can be found in Item 3. Key Information Risk Factors and elsewhere in this document.

Except as required by law, SMIC undertakes no obligation and does not intend to update any forward-looking statement, whether as a result of new information, future events or otherwise.

ADDITIONAL INFORMATION

References in this annual report to:

China or the PRC are to the People s Republic of China, excluding for the purpose of this annual report, Hong Kong, Macau and Taiwan;

HK$ are to Hong Kong dollars;

Rmb are to Renminbi, the legal currency of China;

US$ are to U.S. dollars;

SEHK or Hong Kong Stock Exchange are to The Stock Exchange of Hong Kong Limited;

SEC are to the U.S. Securities and Exchange Commission;

NYSE or New York Stock Exchange are to the New York Stock Exchange, Inc.;

global offering are to the initial public offering of our ADSs and our ordinary shares, which offering was completed on March 18, 2004; and

IPO registration statement are to our registration statement on Form F-1 (File No. 333-112720), as filed with the Securities and Exchange Commission on March 11, 2004, sections of which are incorporated by reference into this annual report.

All references in this annual report to silicon wafer quantities are to 8-inch wafer equivalents, unless otherwise specified. Conversion of quantities of 12-inch wafers to 8-inch wafer equivalents is achieved by multiplying the number of 12-inch wafers by 2.25. When we refer to the capacity of wafer fabrication facilities, we are referring to the installed capacity based on specifications established by the manufacturers of the equipment used in those facilities. References to key process technology nodes, such as 0.35 micron, 0.25 micron, 0.18 micron, 0.15 micron, 0.13 micron, and 90 nanometer include the stated resolution of the process technology, as well as intermediate resolutions down to but not including the next key process technology node of finer resolution. For example, when we state 0.25 micron process technology, that also includes 0.22 micron, 0.21 micron, 0.20 micron and 0.19 micron technologies, 0.18 micron process technology also includes 0.17 micron and 0.16 micron technologies; 0.15 micron process technology includes 0.14 micron technology; and 0.13 micron process technology includes 0.11 micron and 0.10 micron technologies.

References to U.S. GAAP mean the generally accepted accounting principles in the United States. Unless otherwise indicated, our financial information presented in this annual report has been prepared in accordance with U.S. GAAP.

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All references to our ordinary shares in this annual report gives effect to the 10-for-1 share split we effected in the form of a share dividend immediately prior to the completion of the global offering. All references to price per ordinary share and price per preference share reflect the share split referenced above.

The Glossary of Technical Terms contained in Annex A of this annual report sets forth the description of certain technical terms and definitions used in this annual report.

This annual report contains translations of certain Hong Kong dollar and Renminbi amounts into U.S. dollars at specified rates. All translations from Hong Kong dollars and Renminbi to U.S. dollars were made (unless otherwise indicated) at the noon buying rates in The City of New York for cable transfers in Hong Kong dollars and Renminbi per US$1.00 as certified for customs purposes by the Federal Reserve Bank of New York. Unless otherwise stated, the translations of Hong Kong dollars and Renminbi into U.S. dollars have been made at the noon buying rates in effect on the date the relevant transaction was completed. No representation is made that the Hong Kong dollar, Renminbi or U.S. dollar amounts referred to in this offering circular could have been or could be converted into U.S. dollars, Hong Kong dollars or Renminbi, as the case may be, at any particular rate or at all. See Risk Factors Risks Related to Conducting Operations in China Devaluation or appreciation in the value of the Renminbi or restrictions on convertibility of the Renminbi could adversely affect our operating results and Risk Factors Risks Related to Our Financial Condition and Business Exchange rate fluctuations could increase our costs, which could adversely affect our operating results and the value of our ADSs for a discussion of the effects on our company of fluctuating exchange rates.

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 Consolidated Financial Data

The summary consolidated financial data presented below as of and for the years ended December 31, 2003, 2004 and 2005 are derived from, and should be read in conjunction with, and are qualified in their entirety by reference to, our audited consolidated financial statements, including the related notes, included elsewhere in this annual report. The selected consolidated financial data as of and for the years ended December 31, 2001 and 2002is derived from audited consolidated financial statements not included in this annual report. The summary consolidated financial data presented below has been prepared in accordance with U.S. GAAP.

Beginning in the first quarter of 2005, we retroactively reclassified certain expenses to disclose financial performance in a manner consistent with the practices of other high-tech companies. All figures presented herein have given effect, where applicable, to this reclassification. Due to the significant increase in the intangible assets resulting from the settlement of the litigation with Taiwan Semiconductor Manufacturing Company Ltd., or TSMC, amortization expenses previously classified in cost of sales and research and development have been reclassified into a single line item, amortization of intangible assets under operating expenses. We believe the reclassification improves the presentation of our financial results and provides more meaningful information to investors. The impact of the reclassification for the years ended December 31, 2004 and December 31, 2003 resulted in a decrease of cost of sales of US$5.2 million and US$3.5 million, a decrease in research and development of US$9.2 million and US$nil, and an increase in amortization of intangible assets expense of US$14.4 million and US$3.5 million, respectively. Share-based compensation is no longer disclosed as a separate line item but has been allocated into cost of sales, research and development, general and administrative, and selling and marketing.

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	For the year ended December 31,				
	2001	2002	2003	2004	2005
	(in US$ thousands, except for per share, per ADS data, percentages and operating data)				
Statement of Operations Data:					
Sales	$	$ 50,315	$ 365,824	$ 974,664	$ 1,171,319
Cost of sales[1]		105,238	359,779	716,225	1,081,588
Gross profit (loss)		(54,923)	6,045	258,439	89,731
Operating expenses:					
Research and development	9,572	38,254	34,913	74,113	78,865
General and administrative	17,316	18,351	29,705	54,038	35,701
Selling and marketing	771	4,776	10,711	10,384	17,713
Litigation settlement				23,153	
Amortization of acquired intangible assets			3,462	14,368	41,251
Total operating expenses	27,659	61,381	78,791	176,056	173,530
Income (loss) from operations	(27,659)	(116,304)	(72,746)	82,383	(83,799)
Other income (expenses):					
Interest income	18,681	10,980	5,616	10,587	11,356
Interest expense		(176)	(1,425)	(13,698)	(38,785)
Foreign currency exchange gain (loss)	197	247	1,523	8,218	(3,355)
Other, net	187	2,650	888	2,441	4,462
Subsidy income	5,942				
Total other income (loss), net	25,007	13,701	6,602	7,548	(26,322)
Income (loss) before income tax	(2,652)	(102,603)	(66,144)	89,931	(110,121)
Income tax current				186	285
Net income (loss) after taxes and before minority interest and loss from equity investment	(2,652)	(102,603)	(66,144)	89,745	(110,406)
Minority interest					251
Loss from equity investment					(1,379)
Net (loss) income	(2,652)	(102,603)	(66,144)	89,745	(111,534)
Deemed dividend on preference shares[2]			37,117	18,840	
(Loss) income attributable to holders of ordinary shares	$ (2,652)	$ (102,603)	$ (103,261)	$ 70,905	$ (111,534)
Income (loss) per ordinary share, basic	$ (0.03)	$ (1.27)	$ (1.14)	$ 0.01	$ (0.01)
Income (loss) per ordinary share, diluted	$ (0.03)	$ (1.27)	$ (1.14)	$ 0.00	$ (0.01)
Ordinary shares used in calculating basic income (loss) per share[3][4]	80,000,000	80,535,800	90,983,200	14,199,163,517	18,184,429,255
Ordinary shares used in calculating diluted income (loss) per share[3][4]	80,000,000	80,535,800	90,983,200	17,934,393,066	18,184,429,255
Income (loss) per ADS, basic[5]				$ 0.25	$ (0.31)
Income (loss) per ADS, diluted[5]				$ 0.20	$ (0.31)
ADS used in calculating basic income (loss) per ADS[5]				283,983,270	363,688,585
ADS used in calculating diluted income (loss) per ADS[5]				358,687,861	363,688,585
Other Financial Data:					
Gross margin		-109.2%	1.7%	26.5%	7.7%
Operating margin		-231.2%	-19.9%	8.5%	-7.2%
Net margin		-203.9%	-18.1%	9.2%	-9.5%
Operating Data:					
Wafers shipped (in units):					

Logic[6]	26,419	188,316	597,533	662,895
Total[7]	82,486	476,451	943,463	1,347,302
Average selling price (in US$):				
Logic[6]	$ 794	$ 896	$ 1,066	$ 962
Total[7]	$ 558	$ 733	$ 979	$ 834

(1) Including amortization of deferred stock compensation for employees directly involved in manufacturing activities.
(2) Deemed dividend represents the difference between the sale and conversion prices of warrants to purchase convertible preference shares we issued and their respective fair market values.
(3) Anti-dilutive preference shares, options and warrants were excluded from the weighted average ordinary shares outstanding for the diluted per share calculation. For 2001, 2002, 2003, and 2005 basic income (loss) per share did not differ from diluted loss per share.
(4) All share information has been adjusted retroactively to reflect the 10-for-1 share split effected upon completion of the global offering of its ordinary shares in March 2004 (the Global Offering).
(5) Fifty ordinary shares equals one American Depository Share (ADS).
(6) Excluding copper interconnects and DRAM wafers.
(7) Including logic, DRAM, copper interconnects and all other wafers.

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	As of December 31,				
	2001	2002	2003	2004	2005
	(in US$ thousands)				
Balance Sheet Data:					
Cash and cash equivalents	$ 178,920	$ 91,864	$ 445,276	$ 607,173	$ 585,797
Short-term investments		27,709	27,165	20,364	13,796
Accounts receivable, net of allowances		20,110	90,539	169,188	241,334
Inventories	4,749	39,826	69,924	144,018	191,238
Total current assets	235,196	185,067	680,882	955,418	1,047,465
Land use rights, net	48,913	49,354	41,935	39,198	34,768
Plant and equipment, net	478,950	1,290,910	1,523,564	3,311,925	3,285,631
Acquired intangible assets, net		14,748	41,120	77,735	195,179
Equity investment					17,820,890
Total assets	763,059	1,540,078	2,290,506	4,384,276	4,583,416
Total current liabilities	249,071	263,655	325,430	730,330	896,038
Total long-term liabilities		405,432	479,961	544,462	622,497
Total liabilities	249,071	669,087	805,391	1,274,792	1,518,535
Minority interest					38,782
Stockholders equity	$ 513,988	$ 870,991	$ 1,485,115	$ 3,109,484	$ 3,026,099

	For the year ended December 31,				
	2001	2002	2003	2004	2005
	(in US$ thousands)				
Cash Flow Data:					
Net income (loss)	$ (2,652)	$ (102,603)	$ (66,145)	$ 89,745	$ (111,534)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:					
Depreciation and amortization	1,445	84,537	233,905	456,961	745,926
Net cash provided by (used in) operating activities	3,360	(48,802)	114,270	518,662	648,105
Purchases of plant and equipment	(459,779)	(761,704)	(453,097)	(1,838,773)	(872,519)
Net cash used in investing activities	(501,779)	(751,144)	(454,498)	(1,826,787)	(859,652)
Net cash provided by financing activities	583,152	712,925	693,497	1,469,764	190,364
Net increase (decrease) in cash and cash equivalents	$ 84,630	$ (87,056)	$ 353,412	$ 161,896	$ (21,376)

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Risk Factors

Risks Related to Our Financial Condition and Business

Our short operating history makes it difficult to evaluate our business and prospects.

We were founded in April 2000 and did not commence commercial production until January 2002. Because of our limited operating history, there may not be an adequate basis upon which to evaluate our future operating results and prospects, and we have only limited insight into the trends that may emerge and may adversely affect our business and operating results.

We may not be able to achieve or maintain profitability, primarily due to our high fixed costs and correspondingly high levels of depreciation expenses.

After over three years of losses from operations totaling in excess of US$216 million, we had operating income of US$82 million in 2004. However, in 2005, our losses from operations totaled $84 million. We may not be able to achieve or maintain profitability on an annual or quarterly basis, primarily because our business is characterized by high fixed costs relating to equipment purchases, which result in correspondingly high levels of depreciation expenses. We will continue to incur high capital expenditures and depreciation expenses as we equip and ramp up additional fabs, expand our capacity at our existing fabs and construct new fabs. Accordingly, we may not be able to achieve or maintain profitability.

The cyclical nature of the semiconductor industry and periodic overcapacity in the industry make our business and operating results particularly vulnerable to economic downturns.

The semiconductor industry has historically been highly cyclical and, at various times, has experienced significant downturns characterized by fluctuations in end-user demand, reduced demand for integrated circuits, rapid erosion of average selling prices and production overcapacity. Companies in the semiconductor industry have expanded aggressively during periods of increased demand in order to have the capacity needed to meet expected demand in the future. If actual demand does not increase or declines, or if companies in the industry expand too aggressively in light of the actual increase in demand, the industry will generally experience a period in which industry-wide capacity exceeds demand. If industry-wide capacity exceeds demand, our operations would be subject to more intense competition, and our results of operations may suffer because of the resulting pricing pressure and capacity underutilization. Severe pricing pressure could result in the overall foundry industry becoming less profitable, at least for the duration of the downturn, and could prevent us from achieving or maintaining profitability. For example, from 2001 to mid-2003, the semiconductor industry experienced a downturn due to a number of factors, including a slowdown in the global economy and in the communications sector. We expect that industry cyclicality will continue. In addition, a slowdown in the growth in demand for, or the continued reduction in selling prices of, devices that use semiconductors may decrease the demand for our services and reduce our profit margins. If we cannot take appropriate or effective actions in a timely manner during future downturns, such as reducing our costs to sufficiently offset declines in demand for our services, our business and operating results may be adversely affected.

Our results of operations may fluctuate from year to year, which may make it difficult to predict our future performance and may result in a decline in the prices of our ordinary shares and ADSs if we fail to meet our expectations or those of the public market analysts and investors in these periods.

Our sales, expenses, and results of operations may fluctuate significantly from year to year due to a number of factors, many of which are outside our control. Our business and operations are subject to a number of factors, including:

- our customers sales outlook, purchasing patterns and inventory adjustments based on general economic conditions or other factors;
- the loss of one or more key customers or the significant reduction or postponement of orders from such customers;
- timing of new technology development and the qualification of this technology by our customers;

timing of our expansion and development of our facilities;

our ability to obtain equipment and raw materials; and

our ability to obtain financing in a timely manner.

Due to the factors noted above and other risks discussed in this section, many of which are beyond our control, you should not rely on year-to-year comparisons to predict our future performance. Unfavorable changes in any of the above factors may adversely affect our business and operating results. In addition, our operating results may be below the expectations of public market analysts and investors in some future periods.

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If the recent trend of increasing demand for foundry services reverses or slows down, we may achieve a lower rate of return on investments than anticipated and our business and operating results will be adversely affected.

The demand for foundry services by IDMs, fabless semiconductor companies and systems companies has been increasing in recent years. We have made and are planning to make significant investments in anticipation of the continuation of this trend. A reversal of, or slowdown in, this trend will likely result in a lower rate of return on our investments than anticipated. For example, if IDMs change their strategy and target greater internal production or become dissatisfied with the services of independent foundry service providers, such as our company, they may reduce their outsourcing of wafer fabrication. In addition, in the event of an industry downturn, in order to maintain their equipment s utilization rates, these IDMs may allocate a smaller portion of their fabricating needs to foundry service providers and perform a greater amount of foundry services for system companies and fabless semiconductor companies. If this occurs, our business and operating results will be adversely affected.

If we are unable to maintain high capacity utilization, optimize the technology and product mix of our services or improve our yields, our margins may substantially decline, thereby adversely affecting our operating results.

Our ability to achieve and maintain profitability depends, in part, on our ability to:

- maintain high capacity utilization, which is the actual number of wafers we produce in relation to our capacity;
- optimize our technology and product mix, which is the relative number of wafers fabricated utilizing higher margin technologies as compared to commodity and lower margin technologies; and
- continuously maintain and improve our yield, which is the percentage of usable fabricated devices on a wafer.

Our capacity utilization affects our operating results because a large percentage of our costs are fixed. In general, more advanced technologies sell for higher prices and higher margins. Therefore, our technology and product mix has a direct impact upon our average selling prices and overall margins. Our yields directly affect our ability to attract and retain customers, as well as the price of our services. If we are unable to maintain high capacity utilization, optimize the technology and product mix of our wafer production and continuously improve our yields, our margins may substantially decline, thereby adversely affecting our operating results.

Our rapid growth has presented significant challenges to our management and administrative systems and resources, and we may experience difficulties managing our growth, particularly as we handle the additional responsibilities of being a public company, which may adversely affect our business and operating results.

Since our inception in 2000, we have grown rapidly. Our wafer shipment and sales grew from zero in 2000 to 1,347,302 wafers and US$1,171.3 million in 2005. During this period, we commenced commercial production at four 8-inch fabs and one 12-inch fab, and the range of process technologies we offered grew significantly. We are also in the process of constructing one additional 12-inch fab at our Shanghai site and have undertaken management contracts to manage the operations of wafer manufacturing facilities in Chengdu and Wuhan, China. At December 31, 2000, we had 122 employees; and at December 31, 2005, we had 9,096 employees. We plan to hire a significant number of additional employees as our fabs in Tianjin and Beijing ramp up and the fab in Shanghai currently under construction becomes operational. This expansion, as well as our participation in a joint venture with Toppan Printing Co., Ltd. and an assembly and testing facility in Chengdu, and the management of wafer manufacturing facilities in Chengdu and Wuhan, China, have presented, and continue to present, significant challenges for our management and administrative systems and resources. If we fail to develop and maintain management and administrative systems and resources sufficient to keep pace with our planned growth or to handle the additional responsibilities of being a public company, we may experience difficulties managing our growth and our business and operating results could be adversely affected.

If we lose one or more of our key personnel without obtaining adequate replacements in a timely manner or if we are unable to retain and recruit skilled personnel, our operations could become disrupted and the growth of our business could be delayed or restricted.

Our success depends on the continued service of our key executive officers, and in particular, Richard Ru Gin Chang, our President and Chief Executive Officer. We do not carry key person insurance on any of our personnel. If we lose the services of any of our key executive officers, it could be very difficult to find, relocate and integrate adequate replacement personnel into our operations, which could seriously harm our

operations and the growth of our business.

We will require an increased number of experienced executives, engineers and other skilled employees in the future to implement our growth plans. There is intense competition for the services of these personnel in the semiconductor industry. In addition, we expect demand for skilled and experienced personnel in China to increase in the future as new wafer fabrication facilities and other similar high technology businesses are established there. If we are unable to retain our existing personnel or attract, assimilate and retain new experienced personnel in the future, our operations could become disrupted and the growth of our business could be delayed or restricted.

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Our customers generally do not place purchase orders far in advance, which makes it difficult for us to predict our future sales, adjust our production costs and efficiently allocate our capacity on a timely basis and could therefore have an adverse effect on our business and operating results.

Our customers generally do not place purchase orders far in advance of the required shipping dates. In addition, due to the cyclical nature of the semiconductor industry, our customers purchase orders have varied significantly from period to period. As a result, we do not typically operate with any significant backlog, which makes it difficult for us to forecast our sales in future periods. Also, since our cost of sales and operating expenses have high fixed cost components, including depreciation and employee costs, we may be unable to adjust our cost structure in a timely manner to compensate for shortfalls in sales. Our current and anticipated customers may not place orders with us in accordance with our expectations or at all. As a result, it may be difficult to plan our capacity, which requires significant lead time to ramp-up and cannot be altered easily. If our capacity does not match our customer demand, we will either be burdened with expensive and unutilized overcapacity or unable to support our customers requirements, both of which could have an adverse effect on our business and results of operations.

Our sales cycles can be long, which could adversely affect our operating results and cause our income stream to be unpredictable.

Our sales cycles, which measure the time between our first contact with a customer and the first shipment of product orders to the customer, vary substantially and can last as long as one year or more, particularly for new technologies. Sales cycles to IDM customers typically take relatively longer since they usually require our engineers to become familiar with the customer s proprietary technology before production can commence. In addition, even after we make the initial product shipments, it may take the customer several more months to reach full production of that product using our foundry services. As a result of these long sales cycles, we may be required to invest substantial time and incur significant expenses in advance of the receipt of any product order and related revenue. Orders ultimately received may not be in accordance with our expectation with respect to product, volume, price or other terms, which could adversely affect our operating results and cause our income stream to be unpredictable.

We must consistently anticipate trends in technology development or else we will be unable to maintain or increase our business and operating margins.

The semiconductor industry is developing rapidly and the related technology is constantly evolving. If we are unable to anticipate the trends in technology development and rapidly develop and implement new and innovative technology that our customers require, we may not be able to produce sufficiently advanced products at competitive prices. As the life cycle for a process technology matures, the average selling price falls. Accordingly, unless we continually upgrade our capability to manufacture any new products that our customers design, our customers may use the services of our competitors instead of ours and the average selling prices of our wafers may fall, which would adversely affect our business and operating margins.

Our sales are dependent upon a small number of customers and any decrease in sales to any of them could adversely affect our results of operations.

We have been dependent on a small number of customers for a substantial portion of our business. For the year ended December 31, 2005, our five largest customers accounted for 64.0% of our total sales. We expect that we will continue to be dependent upon a relatively limited number of customers for a significant portion of our sales. Sales generated from these customers, individually or in the aggregate, may not reach or exceed our expectations or historical levels in any future period. Our sales could be significantly reduced if any of these customers cancels or reduces its orders, significantly changes its product delivery schedule, or demands lower prices, which would have an adverse effect on our results of operations.

Since our operating cash flows will not be sufficient to cover our planned capital expenditures, we will require additional external financing, which may not be available on acceptable terms or at all. Any failure to raise adequate funds in a timely manner could adversely affect our business and operating results.

In 2005, our capital expenditures totaled approximately US$903 million and we currently expect our capital expenditures in 2006 to total approximately US$1,100 million. These capital expenditures will be used primarily to expand our operations at our mega-fabs in Shanghai and Beijing and fab in Tianjin. In addition, our actual expenditures may exceed our planned expenditures for a variety of reasons, including changes in our business plan, our process technology, market conditions, equipment prices, customer requirements or interest rates. Future acquisitions, mergers, strategic investments, or other developments also may require additional financing. The amount of capital required to meet our growth and development targets is difficult to predict in the highly cyclical and rapidly changing semiconductor industry.

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Our operating cash flows may not be sufficient to meet our capital expenditure requirements in 2006. If our operating cash flows are insufficient, we plan to fund the expected shortfall through bank loans. If necessary, we will also explore other forms of external financing. Our ability to obtain external financing is subject to a variety of uncertainties, including:

- our future financial condition, results of operations and cash flows;
- general market conditions for financing activities of semiconductor companies;
- our future stock price; and
- our future credit rating.

External financing may not be available in a timely manner, on acceptable terms, or at all. Since our capacity expansion is a key component of our overall business strategy, any failure to raise adequate funds could adversely affect our business and operating results.

We have a high level of debt. If we are unable to make interest and principal payments on our debt, it could seriously harm our company.

We currently have a significant amount of debt. The agreements relating to these loans contain covenants such as financial and other restrictive covenants which are customary to loan documents. See Operating and Financial Review and Prospects Liquidity and Capital Resources. A breach of our loan agreements could have important consequences for our company. For example, they could:

- increase our vulnerability to general adverse economic and industry conditions;
- limit our ability to pursue own growth plan and technology upgrades and migrations;
- require us to dedicate a substantial portion of our cash flow from operations to payments on our debt, thereby reducing the availability of our cash flow to fund capital expenditures, working capital and other general corporate purposes;
- limit our flexibility in planning for, or reacting to, changes in our business and the semiconductor industry;
- limit our ability to incur additional borrowings or raise additional financing through equity or debt instruments; and
- restrict our ability to receive dividends from and transfer funds from our Chinese operating subsidiaries.

We cannot assure you that we will be able to make interest and principal payments on debt incurred in connection with our growth if our cash flow from operations are lower than expected.

The construction and equipping of new fabs and the expansion of existing fabs are subject to certain risks that could result in delays or cost overruns, which could require us to expend additional capital and adversely affect our business and operating results.

We plan to continue to expand our business through the development of new fabs. We are building the shell for a 12-inch fab located on our Shanghai site and plan to expand significantly the capacity at our existing fabs in Beijing. There are a number of events that could delay these expansion projects or increase the costs of building and equipping these or future fabs in accordance with our plans. Such potential events

include, but are not limited to:

- shortages and late delivery of building materials and facility equipment;
- delays in the delivery, installation, commissioning and qualification of our manufacturing equipment;
- seasonal factors, such as a long and intensive wet season that limits construction;
- labor disputes;
- design or construction changes with respect to building spaces or equipment layout;
- delays in securing the necessary governmental approvals and land use rights; and
- technological, capacity and other changes to our plans for new fabs necessitated by changes in market conditions.

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As a result, our projections relating to capacity, process technology capabilities or technology developments may significantly differ from actual capacity, process technology capabilities or technology developments.

Delays in the construction and equipping or expansion of any of our fabs could result in the loss or delayed receipt of earnings, an increase in financing costs, or the failure to meet profit and earnings projections, any of which would adversely affect our business and operating results.

If we cannot compete successfully in our industry, particularly in China, our results of operations and financial condition will be adversely affected.

The worldwide semiconductor foundry industry is highly competitive. We compete with other foundries, such as TSMC, United Microelectronics Corporation, or UMC, and Chartered Semiconductor Manufacturing Ltd., or Chartered Semiconductor, as well as the foundry services offered by some IDMs, such as IBM. We also compete with smaller semiconductor foundries in China, Korea, Malaysia and other countries. Some of our competitors have greater access to capital and substantially higher capacity, longer or more established relationships with their customers, superior research and development capability, and greater marketing and other resources than we do. As a result, these companies may be able to compete more aggressively over a longer period of time than we can.

Our competitors have established operations in mainland China in order to compete for the growing domestic market in China. TSMC has commenced commercial production at its fab in China, and UMC has established a relationship with a fab in commercial production in China. We understand that the ability of these fabs to manufacture wafers using certain more advanced technologies is subject to restrictions by the home jurisdiction of TSMC and UMC. Such restrictions could be reduced or lifted at any time, which may lead to increased domestic competition with such competitors and adversely affect our business and operating results.

Our ability to compete successfully depends to some extent upon factors outside of our control, including import and export controls, exchange controls, exchange rate fluctuations, interest rate fluctuations and political developments. If we cannot compete successfully in our industry or are unable to maintain our position as a leading foundry in China, our results of operations and financial condition will be adversely affected.

We may be unable to obtain in a timely manner and at a reasonable cost the equipment necessary for our business and therefore may be unable to achieve our expansion plans or meet our customers orders, which could negatively impact our competitiveness, financial condition and results of operations.

The semiconductor industry is capital-intensive and requires investment in advanced equipment that is available from a limited number of manufacturers. The market for equipment used in semiconductor foundries is characterized, from time to time, by significant demand, limited supply and long delivery cycles. Our business plan depends upon our ability to obtain our required equipment in a timely manner and at acceptable prices. During times of significant demand for the types of equipment we use, lead times for delivery can be as long as one year. Shortages of equipment could result in an increase in equipment prices and longer delivery times. If we are unable to obtain equipment in a timely manner and at a reasonable cost, we may be unable to achieve our expansion plans or meet our customers orders, which could negatively impact our competitiveness, financial condition, and results of operations.

We expect to have an ongoing need to obtain licenses for the proprietary technology of others, which subjects us to the payment of license fees and potential delays in the development and marketing of our products.

While we continue to develop and pursue patent protection for our own technologies, we expect to continue to rely on third party license arrangements to enable us to manufacture certain advanced wafers. As of December 31, 2005, we had been granted seventy-three patents, thirty-eight in Taiwan, eleven in the U.S., and twenty-four in China, whereas we believe our competitors and other industry participants have been issued numerous patents concerning wafer fabrication in multiple jurisdictions. Our limited patent portfolio may in the future adversely affect our ability to obtain licenses to the proprietary technology of others on favorable license terms due to our inability to offer cross-licensing arrangements. The fees associated with such licenses could adversely affect our financial condition and operating results. They might also render our services less competitive. If for any reason we are unable to license necessary technology on acceptable terms, it may become necessary for us to develop alternative technology internally, which could be costly and delay the marketing and delivery of key products and therefore have an adverse effect on our business and operating results. In addition, we may be unable to independently develop the technology required by our customers on a timely basis or at all, in which case our customers may purchase wafers from our competitors.

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We may be subject to claims of intellectual property rights infringement owing to the nature of our industry, our limited patent portfolio and limitations of the indemnification provisions in our technology license agreements. These claims could adversely affect our business and operating results.

There is frequent intellectual property litigation, involving patents, copyrights, trade secrets, mask works and other intellectual property subject matters, in our industry. In some cases, a company can avoid or settle litigation on favorable terms because it possesses patents that can be asserted against the plaintiff. The limited size of our current patent portfolio will not likely place us in such a bargaining position. Moreover, some of our technology license agreements with our major technology partners do not provide for us to be indemnified in the event that the processes we license pursuant to such agreements infringe third party intellectual property rights. We could be sued for allegedly infringing one or more patents as to which we will be unable to obtain a license and unable to design around. As a result, we would be foreclosed from manufacturing or selling the products which are dependent upon such technology, which could have a material adverse effect on our business. We may litigate the issues of whether these patents are valid or infringed, but in the event of a loss we could be required to pay substantial monetary damages and be enjoined from further production or sale of such products.

If we breach the terms and conditions of the settlement agreement regarding the patent and trade secret litigation with TSMC, we may be required to accelerate the payment of the then outstanding amounts due under the settlement agreement and the litigation proceedings may be recommenced or re-filed. If the litigation is recommenced and we are unable to successfully defend ourselves, we may be required to pay damages, obtain a license from TSMC, or discontinue sales of certain of our products in the United States.

In December 2003, we became the subject of a lawsuit in U.S. federal district court brought by TSMC relating to alleged infringement of five U.S. patents and misappropriation of alleged trade secrets relating to methods for conducting semiconductor fab operations and manufacturing integrated circuits. After the dismissal without prejudice of the trade secret misappropriation claims by the U.S. federal district court on April 21, 2004, TSMC refiled the same claims in California State Superior Court and alleged infringement of an additional 6 patents in the U.S. federal district court lawsuit. In August 2004, TSMC filed a complaint with the U.S. International Trade Commission (ITC) alleging similar trade secret misappropriation claims and asserting 3 new patent infringement claims and simultaneously filed another patent infringement suit in federal district court on the same 3 patents as alleged in the ITC complaint. Prior to the start of the initial lawsuit in the United States, TSMC had instituted a legal proceeding in Taiwan in January 2002 that alleged improper hiring practices and trade secret misappropriation. In the Taiwan proceeding, the Hsinchu District Court in Taiwan issued an ex parte provisional injunction that prohibits our wholly owned subsidiary, Semiconductor Manufacturing International (Shanghai) Corporation, or SMIC Shanghai, and Richard Ru Gin Chang, our president and chief executive officer, from improperly soliciting or hiring certain categories of employees of TSMC or causing such employees to divulge to us, or use, trade secrets of TSMC.

On January 31, 2005, we entered into a settlement agreement with TSMC that provides for the dismissal of all pending legal actions without prejudice between TSMC and our company in U.S. federal district court, California State Superior Court, the ITC and Taiwan District Court. In the settlement agreement, TSMC covenants not to sue us for itemized acts of trade secret misappropriation as alleged in the complaints, although the settlement does not grant a license to use any of TSMC s trade secrets. Furthermore, the parties also entered into a patent cross-license agreement under which each party will license the other party s patent portfolio through December 2010. As a part of the settlement, we also agreed to pay TSMC an aggregate amount of US$175 million, in installments of US$30 million each year for five years and US$25 million in the sixth year.

The patent cross-license agreement and settlement agreement are terminable upon a breach of the settlement agreement by SMIC. Any such breach may result in the filing of a lawsuit relating to such breach, recommencement or re-filing of the legal proceedings and acceleration of the outstanding monetary payment obligations under the settlement agreement. If the legal proceedings were reinstituted or re-filed and TSMC were to succeed on its patent infringement claims in the United States, we may be ordered to pay damages for past infringement, discontinue sales of certain of our products in the United States and, as to future sales, either enter into a license agreement with TSMC or incur the cost of designing around the patents that were found to have been infringed, if any. If TSMC were to succeed on its trade secret claim, it could seek damages or an injunction, the materiality of which would depend on the amount, nature and significance of the trade secrets we would be found to have misappropriated, if any. The occurrence of any of these events could have a material adverse effect on our business and operating results and, in any event, the cost of litigation could be substantial.

If our relationships with our technology partners deteriorate or we are unable to enter into new technology alliances, we may not be able to continue providing our customers with leading edge process technology, which could adversely affect our competitive position and operating results.

Enhancing our process technologies is critical to our ability to provide high quality services for our customers. We intend to continue to advance our process technologies through internal research and development efforts and technology alliances with other companies. Although we have an internal research and development team focused on developing new process technologies, we depend upon our technology partners to

advance our portfolio of process technologies. We currently have joint technology development arrangements and technology sharing arrangements with several companies and research institutes. If we are unable to

continue our technology alliances with these entities, or maintain on mutually beneficial terms any of our other joint development arrangements, research and development alliances and other similar agreements, or are unable to enter into new technology alliances with other leading developers of semiconductor technology, we may not be able to continue providing our customers with leading edge process technology, which could adversely affect our competitive position and operating results.

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We may be unable to integrate successfully the Beijing mega-fab and fab in Tianjin with our existing operations in Shanghai in a timely manner, which could adversely affect our operating results.

The ramp-up of our Beijing mega-fab and fab in Tianjin involve the integration of new facilities with our existing operations in Shanghai, which we refer to as our Shanghai mega-fab. These facilities are located in three different locations and have different operating configurations. We are currently in the process of implementing this integration.

The challenges of combining the operations of our Beijing mega-fab and Tianjin fab with the operations of our Shanghai mega-fab include integrating technologies with different wafer sizes, integrating personnel with diverse business backgrounds, combining different corporate cultures and managing a geographically dispersed organization. Operating in three different locations also requires us to liaise with three different sets of local and municipal governmental authorities, which places additional administrative burdens on our management.

As a result of these factors, we may be unable to complete successfully this integration in a timely manner, which could adversely affect our operating results.

Our internal controls and management systems are not currently consistent with international practices in certain respects and we are in the process of improving these controls and systems to enable us to certify the effectiveness of our internal controls under the Sarbanes-Oxley Act of 2002. Our failure to timely and successfully upgrade these controls and systems could subject us to regulatory actions and affect the price of our ordinary shares and ADSs.

In June 2004, the Public Company Accounting Oversight Board, or PCAOB, adopted rules for purposes of implementing Section 404 of the Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act. Pursuant to the Sarbanes-Oxley Act and the various rules and regulations adopted pursuant thereto or in conjunction therewith, we are required, for fiscal year 2006, to perform an evaluation of our internal controls over financial reporting and file an assessment of its effectiveness with the SEC. For fiscal year 2006, our external auditors are required to attest to and report on our managements assessment on internal control over financial reporting.

We have engaged PricewaterhouseCoopers LLC as an outside consultant to review our current internal controls and assist us in implementing measures to comply with Section 404 of the Sarbanes-Oxley Act. Although we are not currently subject to Section 404, we have examined the definitions contained in PCAOB pronouncement. The PCAOB rules describe certain circumstances as being both significant deficiencies and strong indicators that a material weakness in internal control over financial reporting exists. PricewaterhouseCoopers has brought to our attention a number of areas in which our current internal controls and management systems may not reduce to a relatively low level the risk of undetected material errors or fraud and could adversely affect our ability to accurately and timely record, process, summarize and report financial data. We have taken and continue to take steps to correct these internal control deficiencies. The efficacy of the steps we have taken to date and the steps we are still in the process of taking to improve the reliability of our financial statements is subject to continued management review supported by confirmation and testing by our internal auditors, as well as audit committee oversight. We cannot be certain that these measures will ensure that we implement and maintain adequate controls over our financial processes and reporting in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations. In addition, we cannot assure you that we will not in the future identify further material weaknesses or significant deficiencies in our internal control over financial reporting that we have not discovered to date.

Beginning with the year ending December 31, 2006, pursuant to Section 404 of the Sarbanes-Oxley Act, our management will be required to deliver a report that assesses the effectiveness of our internal control over financial reporting, and we will be required to deliver an attestation report of our auditors on our management s assessment of and operating effectiveness of internal controls. An inability to complete and document this assessment could result in a scope limitation qualification or a scope limitation disclaimer by our auditors on their attestation of our internal controls. If a material weakness were identified with respect to our internal control over financial reporting, we would not be able to conclude that our internal controls over financial reporting were effective, which could result in the inability of our external auditors to deliver an unqualified report, or any report, on our internal controls. Moreover, even if our management does conclude that our internal controls over financial reporting are effective, if as of the end of fiscal year 2006, our external auditors are not satisfied with our internal controls, the level at which our controls are documented, designed, operated or reviewed, or if our external auditors interpret the requirements, rules or regulations differently from us, then they may decline to attest to our management s assessment or may issue a report that is qualified. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our securities.

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Global or regional economic, political and social conditions could adversely affect our business and operating results.

External factors such as potential terrorist attacks, acts of war, financial crises or geopolitical and social turmoil in those parts of the world that serve as markets for our products could significantly adversely affect our business and operating results in ways that cannot presently be predicted. These uncertainties could make it difficult for our customers and us to accurately plan future business activities. More generally, these geopolitical, social and economic conditions could result in increased volatility in worldwide financial markets and economies that could adversely impact our sales. We are not insured for losses and interruptions caused by terrorist acts or acts of war. Therefore, any of these events or circumstances could adversely affect our business and operating results.

Exchange rate fluctuations could increase our costs, which could adversely affect our operating results and the value of our ADSs.

Our financial statements are prepared in U.S. dollars. Our sales are generally denominated in U.S. dollars and our operating expenses and capital expenditures are generally denominated in U.S. dollars, Japanese Yen, Euros and Renminbi. Although we enter into foreign currency forward exchange contracts, we are still affected by fluctuations in exchange rates between the U.S. dollar and each of the Japanese Yen, the Euro and the Renminbi. Any significant fluctuations among these currencies may lead to an increase in our costs, which could adversely affect our operating results. See Risks Related to Conducting Operations in China Devaluation or appreciation in the value of the Renminbi or restrictions on convertibility of the Renminbi could adversely affect our business and operating results for a discussion of risks relating to the Renminbi.

Fluctuations in the exchange rate of the Hong Kong dollar against the U.S. dollar will affect the U.S. dollar value of the ADSs, since our ordinary shares are listed and traded on the Hong Kong Stock Exchange and the price of such shares are denominated in Hong Kong dollars. While the Hong Kong government has continued to pursue a fixed exchange rate policy, with the Hong Kong dollar trading in the range of HK$7.75 to HK$7.85 per US$1.00, we cannot assure you that such policy will be maintained. Exchange rate fluctuations also will affect the amount of U.S. dollars received upon the payment of any cash dividends or other distributions paid in Hong Kong dollars and the Hong Kong dollar proceeds received from any sales of ordinary shares. Therefore, such fluctuations could also adversely affect the value of our ADSs.

Our earnings may be adversely affected once we change our accounting policies with respect to the expensing of stock options.

For the fiscal year ended December 31, 2005, we accounted for share-based compensation transactions, such as stock option grants, using the intrinsic value method (based on the discount to fair market value on the date of grant) as prescribed by Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees*. On December 16, 2004, the Financial Accounting Standards Board, FASB, issued FAS 123R, *Share-Based Payment, an amendment of FASB Statements No. 123 and 95*, which, as amended in April 2005, requires that such transactions be accounted for using a fair value based method and recognized as expenses in our consolidated statement of income, effective as of the start of our fiscal reporting period commencing after December 15, 2005, the effective date. FAS 123R requires that a modified prospective method be used to account for share-based compensation transactions. Under FAS 123R, we will be required to expense the fair value of our stock option grants rather than expensing the intrinsic value of stock options as we do now. This means that the fair value of new awards granted on or after the effective date (plus unvested awards as of the effective date) will be expensed over the remaining vesting period. This change in the accounting policy with respect to the treatment of employee stock option grants may adversely affect our earnings and may have a significant impact on our consolidated statement of operations.

Implementation of FAS 123R may result in inconsistent financial disclosure.

Under FAS 123R, we have the option of adopting a modified retrospective application. Because we have decided not to adopt a modified retrospective application, our financial performance for periods when FAS 123R accounting is not applied will not be comparable with the performance for periods when FAS 123R accounting is applied. If a comparison is made, performance for periods when FAS 123R is applied may appear to be significantly below performance for earlier periods.

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Risks Related to Manufacturing

Our manufacturing processes are highly complex, costly and potentially vulnerable to impurities and other disruptions, which could significantly increase our costs and delay product shipments to our customers.

Our manufacturing processes are highly complex, require advanced and costly equipment, demand a high degree of precision and may have to be modified to improve yields and product performance. Dust and other impurities, difficulties in the fabrication process or defects with respect to the equipment or facilities used can lower yields, cause quality control problems, interrupt production or result in losses of products in process. As system complexity has increased and process technology has become more advanced, manufacturing tolerances have been reduced and requirements for precision have become even more demanding. As a result, we may experience production difficulties, which could significantly increase our costs and delay product shipments to our customers.

We may have difficulty in ramping up production, which could cause delays in product deliveries and loss of customers and adversely affect our business and operating results.

As is common in the semiconductor industry, we may experience difficulty in ramping up production at new or existing facilities, such as our Beijing mega-fab and our fab in Tianjin in which we expect to add a significant amount of new equipment. This could be due to a variety of factors, including hiring and training of new personnel, implementing new fabrication processes, recalibrating and requalifying existing processes and the inability to achieve required yield levels.

In the future, we may face construction delays or interruptions, infrastructure failure, or delays in upgrading or expanding existing facilities or changing our process technologies, which may adversely affect our ability to ramp up production in accordance with our plans. Our failure to ramp up our production on a timely basis could cause delays in product deliveries, which may result in the loss of customers and sales. It could also prevent us from recouping our investments in a timely manner or at all, and adversely affect our business and operating results.

We have announced agreements to form joint ventures that, if not successful, may adversely impact our business and operating results.

In July 2004, we announced an agreement with Toppan Printing Co., Ltd., to establish Toppan SMIC Electronics (Shanghai) Co., Ltd., a joint venture in Shanghai, to manufacture color filters and micro-lenses for CMOS image sensors. In May 2005, we announced an agreement with United Test and Assembly Center Ltd. to establish a joint venture in Chengdu to provide assembly and testing services for memory and logic devices.

The results of the joint ventures may be reflected in our operating results to the extent of our ownership interest, and losses of the joint ventures could adversely impact our operating results. As a result of our ownership of Toppan SMIC Electronics (Shanghai) Co., Ltd., we recorded a loss of US$1.4 million in 2005. Operational challenges confront the joint ventures. Integration of assets and operations being contributed by each partner will involve complex activities that must be completed in a short period of time. The new joint ventures are likely to confront numerous challenges in commencing their operations and operating successfully. The business of the joint ventures will be subject to operational risks that would normally arise for these types of businesses pertaining to manufacturing, sales, service, marketing, and corporate functions. Competition in the CMOS image sensor market and semiconductor assembly and testing industry will involve challenges from numerous, well-established companies with substantial resources and significant market share.

If the joint ventures are not successful or less successful than we anticipate, we may incur higher costs for performing assembly and testing services through our current partners or for manufacturing color filters and micro-lenses, which typically require mature technologies and thus command a lower wafer price and generate lower margins, at our existing fabs. Either result may adversely affect our business and operating results.

If we are unable to obtain raw materials and spare parts in a timely manner, our production schedules could be delayed and our costs could increase.

We depend on suppliers of raw materials, such as silicon wafers, gases and chemicals, and spare equipment parts, in order to maintain our production processes. To maintain operations, we must obtain from our suppliers sufficient quantities of quality raw materials and spare equipment parts at acceptable prices and in a timely manner. The most important raw material used in our production is silicon in the form of raw wafers. We currently purchase approximately 77.1% of our overall raw wafer requirements from our top three raw wafer suppliers. In addition, a portion of our gas and chemical requirements currently must be sourced from outside China. We may not be able to obtain adequate supplies of raw materials and spare parts in a timely manner and at a reasonable cost. In addition, from time to time, we may need to reject raw materials and parts that do not meet our specifications, resulting in potential delays or declines in output. If the supply of raw materials and

necessary spare parts is substantially reduced or if there are significant increases in their prices, we may incur additional costs to acquire sufficient quantities of these parts and materials to maintain our production schedules and commitments to customers.

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Our production may be interrupted, limited or delayed if we cannot maintain sufficient sources of fresh water and electricity, which could adversely affect our business and operating results.

The semiconductor fabrication process requires extensive amounts of fresh water and a stable source of electricity. As our production capabilities increase and our business grows, our requirements for these factors will grow substantially. While we have not, to date, experienced any instances of the lack of sufficient supplies of water or material disruptions in the electricity supply to any of our fabs, we may not have access to sufficient supplies of water and electricity to accommodate our planned growth. Droughts, pipeline interruptions, power interruptions, electricity shortages or government intervention, particularly in the form of rationing, are factors that could restrict our access to these utilities in the areas in which our fabs are located. In particular, our fab in Tianjin and our Beijing mega-fab are located in areas that are susceptible to severe water shortages during the summer months. If there is an insufficient supply of fresh water or electricity to satisfy our requirements, we may need to limit or delay our production, which could adversely affect our business and operating results. In addition, a power outage, even of very limited duration, could result in a loss of wafers in production and a deterioration in yield.

We are subject to the risk of damage due to fires or explosions because the materials we use in our manufacturing processes are highly flammable. Such damage could temporarily reduce our manufacturing capacity, thereby adversely affecting our business and operating results.

We use highly flammable materials such as silane and hydrogen in our manufacturing processes and are therefore subject to the risk of loss arising from explosions and fires. While we have not, to date, experienced any explosion or fire due to the nature of our raw materials, the risk of explosion and fire associated with these materials cannot be completely eliminated. Although we maintain comprehensive fire insurance and insurance for the loss of property and the loss of profit resulting from business interruption, our insurance coverage may not be sufficient to cover all of our potential losses due to an explosion or fire. If any of our fabs were to be damaged or cease operations as a result of an explosion or fire, it could temporarily reduce our manufacturing capacity, which could adversely affect our business and operating results.

Our Beijing mega-fab is located in an area that is susceptible to seasonal dust storms, which could create impurities in the production process at these facilities and require us to take additional measures or spend additional capital to further insulate these fabs from dust, thereby adversely affecting our business and operating results.

The location of our Beijing mega-fab makes it susceptible to seasonal dust storms, which could cause dust particles to enter the buildings and affect the production process. Although we are constructing precautionary filtration systems, these may not adequately insulate the Beijing mega-fab against dust contamination. If dust were to affect production in the Beijing mega-fab, we could experience quality control problems, losses of products in process and delays in shipping products to our customers. In addition, we may have to spend additional capital to further insulate the Beijing mega-fab from dust if our current precautionary measures are insufficient. The occurrence of any of these events could adversely affect our business and operating results.

Our operations may be delayed or interrupted and our business could suffer as a result of steps we may be required to take in order to comply with environmental regulations.

We are subject to a variety of Chinese environmental regulations relating to the use, discharge and disposal of toxic or otherwise hazardous materials used in our production processes. Any failure or any claim that we have failed to comply with these regulations could cause delays in our production and capacity expansion and affect our company s public image, either of which could harm our business. In addition, any failure to comply with these regulations could subject us to substantial fines or other liabilities or require us to suspend or adversely modify our operations.

Risks Related to Conducting Operations in China

Our business is subject to extensive government regulation and benefits from certain government incentives, and changes in these regulations or incentives could adversely affect our business and operating results.

The Chinese government has broad discretion and authority to regulate the technology industry in China. China s government has also implemented policies from time to time to regulate economic expansion in China. The economy of China has been transitioning from a planned economy to a market-oriented economy. Although in recent years the Chinese government has implemented measures emphasizing the utilization of market forces for economic reform, the reduction of state ownership of productive assets, and the establishment of sound corporate governance in business enterprises, a substantial portion of productive assets in China is still owned by the Chinese government. In addition, the Chinese government continues to play a significant role in regulating industrial development. It also exercises significant control over China s economic growth through the allocation of resources, controlling payment of foreign currency-denominated obligations, setting monetary policy,

and providing preferential treatment to particular industries or companies. New regulations or the readjustment of previously implemented regulations could require us to change our business plan, increase our costs or limit our ability to sell products and conduct activities in China, which could adversely affect our business and operating results.

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In addition, the Chinese government and provincial and local governments have provided, and continue to provide, various incentives to domestic companies in the semiconductor industry, including our company, in order to encourage the development of the industry. Such incentives include tax rebates, reduced tax rates, favorable lending policies, and other measures. Any of these incentives could be reduced or eliminated by governmental authorities at any time. For example, in 2004, the Chinese government announced that by April 1, 2005, the preferential value-added tax policies, which previously entitled certain qualified companies to receive a refund of the amount exceeding 3% of the actual value-added tax burden relating to self-made integrated circuit product sales, would be eliminated. While we have not previously benefited materially from such preferential value-added tax policies, any reduction or elimination of other incentives currently provided to us could adversely affect our business and operating results.

Because our business model depends on growth in the electronics manufacturing supply chain in China, any slowdown in this growth could adversely affect our business and operating results.

Our business is dependent upon the economy and the business environment in China. In particular, our growth strategy is based upon the assumption that demand in China for devices that use semiconductors will continue to grow. Therefore, any slowdown in the growth of consumer demand in China for products that use semiconductors, such as computers, mobile phones or other consumer electronics, could have a serious adverse effect on our business. In addition, our business plan assumes that an increasing number of non-domestic IDMs, fabless semiconductor companies and systems companies will establish operations in China. Any decline in the rate of migration to China of semiconductor design companies or companies that require semiconductors as components for their products could adversely affect our business and operating results.

Limits placed on exports into China could substantially harm our business and operating results.

The growth of our business will depend on the ability of our suppliers to export, and our ability to import, equipment, materials, spare parts, process know-how and other technologies and hardware into China. Any restrictions placed on the import and export of these products and technologies could adversely impact our growth and substantially harm our business. In particular, the United States requires our suppliers and us to obtain licenses to export certain products, equipment, materials, spare parts and technologies from that country. If we or our suppliers are unable to obtain export licenses in a timely manner, our business and operating results could be adversely affected.

In July 1996, thirty-three countries ratified the Wassenaar Arrangement on Export Controls for Conventional Arms and Dual-Use Goods and Technologies, which established a worldwide arrangement to restrict the transfer of conventional arms and dual-use goods and technologies. Under the terms of the Wassenaar Arrangement, the participating countries, including the United States, have restricted exports to China of technology, equipment, materials and spare parts that potentially may be used for military purposes in addition to their commercial applications. To the extent that technology, equipment, materials or spare parts used in our manufacturing processes are or become subject to the restrictions of the arrangement, our ability to procure these products and technology could be impaired, which could adversely affect our business and operating results. There could also be a change in the export license regulatory regime in the countries from which we purchase our equipment, materials and spare parts that could delay our ability to obtain export licenses for the equipment, materials, spare parts and technology we require to conduct our business.

Devaluation or appreciation in the value of the Renminbi or restrictions on convertibility of the Renminbi could adversely affect our business and operating results.

The value of the Renminbi is subject to changes in China s governmental policies and to international economic and political developments. Since 1994, the conversion of Renminbi into foreign currencies, including Hong Kong and U.S. dollars, has been based on rates set by the People s Bank of China (PBOC), which are set daily based on the previous day s interbank foreign exchange market rates and current exchange rates on the world financial markets. The Renminbi to U.S. dollar exchange rate experienced significant volatility prior to 1994, including periods of sharp devaluation. On July 21, 2005, the PBOC announced an adjustment of the exchange rate of the U.S. dollar to Renminbi from 1:8.27 to 1:8.11 and modified the system by which the exchange rates are determined. This adjustment has resulted in an approximately 2.0% appreciation of the Renminbi against the U.S. dollar. There remains significant international pressure on the PRC government to adopt an even more flexible currency policy, which could result in a further and more significant appreciation of the Renminbi against the U.S. dollar. As a result, the exchange rate may become volatile and the Renminbi may be devalued again against the U.S. dollar or other currencies, or the Renminbi may be permitted to enter into a full or limited free float, which may result in an appreciation in the value of the Renminbi against the U.S. dollar, any of which could have an adverse affect on our business and operating results.

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In the past, financial markets in many Asian countries have experienced severe volatility and, as a result, some Asian currencies have experienced significant devaluation from time to time. The devaluation of some Asian currencies may have the effect of rendering exports from China more expensive and less competitive and therefore place pressure on China s government to devalue the Renminbi. An appreciation in the value of the Renminbi could have a similar effect. Any devaluation of the Renminbi could result in an increase in volatility of Asian currency and capital markets. Future volatility of Asian financial markets could have an adverse impact on our ability to expand our product sales into Asian markets outside of China.

We receive a portion of our sales in Renminbi, which is currently not a freely convertible currency. For the year ended December 31, 2005, approximately 5.8% of our sales were denominated in Renminbi. While we have used these proceeds for the payment of our Renminbi expenses, we may in the future need to convert these sales into foreign currencies to allow us to purchase imported materials and equipment, particularly as we expect the proportion of our sales to China-based companies to increase in the future. Under China s existing foreign exchange regulations, payments of current account items, including profit distributions, interest payments and expenditures from trade may be made in foreign currencies without government approval, except for certain procedural requirements. The Chinese government may, however, at its discretion, restrict access in the future to foreign currencies for current account transactions and prohibit us from converting our Renminbi sales into foreign currencies. If this were to occur, we may not be able to meet our foreign currency payment obligations.

China s entry into the World Trade Organization has resulted in lower Chinese tariff levels, which benefit our competitors from outside China and could adversely affect our business and operating results.

As a result of joining the World Trade Organization, or WTO, China has reduced its average rate of import tariffs to 11.5% in 2003 and will further reduce it to 10% by 2008. The import tariff for some information technology-related products has been reduced to zero. As a consequence, we expect stronger competition in China from our foreign competitors, particularly in terms of product pricing, which could adversely affect our business and operating results.

China s legal system embodies uncertainties that could adversely affect our business and operating results.

Since 1979, many new laws and regulations covering general economic matters have been promulgated in China. Despite this activity to develop the legal system, China s system of laws is not yet complete. Even where adequate law exists in China, enforcement of existing laws or contracts based on existing law may be uncertain and sporadic, and it may be difficult to obtain swift and equitable enforcement or to obtain enforcement of a judgment by a court of another jurisdiction. The relative inexperience of China s judiciary in many cases creates additional uncertainty as to the outcome of any litigation. In addition, interpretation of statutes and regulations may be subject to government policies reflecting domestic political changes.

Our activities in China will be subject to administrative review and approval by various national and local agencies of China s government. See Item 4 Information on the Company Regulation. Because of the changes occurring in China s legal and regulatory structure, we may not be able to secure the requisite governmental approval for our activities. Failure to obtain the requisite governmental approval for any of our activities could adversely affect our business and operating results.

Our corporate structure may restrict our ability to receive dividends from, and transfer funds to, our Chinese operating subsidiaries, which could restrict our ability to act in response to changing market conditions and reallocate funds from one Chinese subsidiary to another in a timely manner.

We are a Cayman Islands holding company and substantially all of our operations are conducted through our Chinese operating subsidiaries, SMIC Shanghai, Semiconductor Manufacturing International (Beijing) Corporation, or SMIC Beijing, and SMIC Tianjin. The ability of these subsidiaries to distribute dividends and other payments to us may be restricted by factors that include changes in applicable foreign exchange and other laws and regulations. In particular, under Chinese law, these operating subsidiaries may only pay dividends after 10% of their net profit has been set aside as reserve funds, unless such reserves have reached at least 50% of their respective registered capital. In addition, the profit available for distribution from our Chinese operating subsidiaries is determined in accordance with generally accepted accounting principles in China. This calculation may differ from the one performed in accordance with U.S. GAAP. As a result, we may not have sufficient distributions from our Chinese subsidiaries to enable necessary profit distributions to us or any distributions to our shareholders in the future, which calculation would be based upon our financial statements prepared under U.S. GAAP.

Distributions by our Chinese subsidiaries to us other than as dividends may be subject to governmental approval and taxation. Any transfer of funds from our company to our Chinese subsidiaries, either as a shareholder loan or as an increase in registered capital, is subject to registration or approval of Chinese governmental authorities, including the relevant administration of foreign exchange and/or the relevant examining and approval authority. In addition, it is not permitted under Chinese law for our Chinese subsidiaries to directly lend money to each other.

Therefore, it is difficult to change our capital expenditure plans once the relevant funds have been remitted from our company to our Chinese subsidiaries. These limitations on the free flow of funds between us and our Chinese subsidiaries could restrict our ability to act in response to changing market conditions and reallocate funds from one Chinese subsidiary to another in a timely manner.

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Risks Related to Ownership of Our Shares and ADSs and Our Trading Markets

Future sales of securities by us or our shareholders may decrease the value of your investment.

Future sales by us or our existing shareholders of substantial amounts of our ordinary shares or ADSs in the public markets could adversely affect market prices prevailing from time to time. In connection with our global offering, we entered into an amended and restated registration rights agreement with Richard Ru Gin Chang and our securityholders prior to our global offering. Under the terms of this agreement, every 180-day period, substantially all of our securityholders that beneficially own, directly or indirectly and whether individually or as a group with its affiliates, more than 7,500,000 of our ordinary shares immediately prior to the global offering, whom we collectively refer to as our large securityholders, may sell 15% of the shares held by such large securityholder immediately prior to the completion of the global offering in an annual, demand or incidental offering or without our consent in the open market or in privately negotiated transactions. We refer to the shares sold as released shares and these sales as permitted sales/transfers. The 15% limit for each 180-day period is cumulative, such that if any large securityholder does not sell or transfer the 15% released shares from a previous 180-day period, any unsold or non-transferred released shares will roll over and may be sold or transferred at any time in the future, together with all other accumulated released shares from previous periods.

In addition, we have entered into an agreement with each of Motorola and MCEL, which are deemed to be large securityholders under the amended and restated registration rights agreement, pursuant to which we have consented to release from the monetization restrictions described above an additional 15% of the shares they each held immediately prior to the completion of the global offering commencing on the date of expiration of the 180-day post-global offering lock-up period and an additional 15% every 180 days thereafter.

Like the 15% limit for each 180-day period applicable to other large securityholders, such 30% limit applicable to Motorola and MCEL is cumulative. In addition, such additional released shares may only be sold or transferred by Motorola or MCEL pursuant to the same terms and conditions applicable to the sale or transfer of their released shares under the amended and restated registration rights agreement. In addition, to the extent that at any time during the term of the amended and restated registration rights agreement we increase the percentage of released shares that may be transferred or sold by any large securityholder who holds more than 1% of our outstanding shares (on a pre-global offering basis) to more than the percentage of released shares that may be transferred or sold by Motorola and MCEL (regardless of whether or not Motorola or MCEL actually sold any released shares), we have consented to increase the percentage of released shares for Motorola and MCEL to match the increased percentage for such large securityholder. We have also agreed with each of Motorola and MCEL that we will not consent to any amendment or waiver of any provision of the amended and restated registration rights agreement that adversely affects either Motorola or MCEL but does not so adversely affect all other parties to the amended and restated registration rights agreement unless such amendment or waiver is approved in writing by Motorola.

An example of a permitted sale pursuant to the terms of the amended and restated registration rights agreement and the agreement we signed with Motorola was the reported sale on or about February 28, 2005 by Motorola and MCEL of an aggregate of 517,489,221 of our ordinary shares, representing approximately 2.8% of our total outstanding shares as of December 31, 2004. Subsequent to the completion of this permitted sale, our price per ordinary share decreased by HK$0.06.

We cannot predict the effect, if any, of a permitted sale or the perception that a permitted sale will occur, on the market price for our ordinary shares or ADSs.

Holders of our ADSs will not have the same voting rights as the holders of our shares and may not receive voting materials in time to be able to exercise their right to vote.

Holders of our ADSs may not be able to exercise voting rights attaching to the shares evidenced by our ADSs on an individual basis. Holders of our ADSs have appointed the depositary or its nominee as their representative to exercise the voting rights attaching to the shares represented by the ADSs. You may not receive voting materials in time to instruct the depositary to vote, and it is possible that you, or persons who hold their ADSs through brokers, dealers or other third parties, will not have the opportunity to exercise a right to vote.

You may not be able to participate in rights offerings and may experience dilution of your holdings as a result.

We may from time to time distribute rights to our shareholders, including rights to acquire our securities. Under the deposit agreement for the ADSs, the depositary will not offer those rights to ADS holders unless both the rights and the underlying securities to be distributed to ADS holders are either registered under the Securities Act or exempt from registration under the Securities Act with respect to all holders of ADSs. We are under no obligation to file a registration statement with respect to any such rights or underlying securities or to endeavor to cause such a registration statement to be declared effective. In addition, we may not be able to take advantage of any exemptions from registration under the Securities Act. Accordingly, holders of our ADSs may be unable to participate in our rights offerings and may experience dilution in their

holdings as a result.

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The laws of the Cayman Islands and China may not provide our shareholders with benefits provided to shareholders of corporations incorporated in the United States.

Our corporate affairs are governed by our memorandum and articles of association, by the Companies Law (2004 Revision) and the common law of the Cayman Islands. The rights of shareholders to take action against our directors, actions by minority shareholders and the fiduciary responsibilities of our directors to us under Cayman Islands law are to a large extent governed by the common law of the Cayman Islands. The common law in the Cayman Islands is derived in part from comparatively limited judicial precedent in the Cayman Islands and from English common law, the decisions of whose courts are of persuasive authority but are not binding on a court in the Cayman Islands. The rights of our shareholders and the fiduciary responsibilities of our directors under Cayman Islands law are not as clearly established as they would be under statutes or judicial precedents in the United States. In particular, the Cayman Islands has a less developed body of securities laws as compared to the United States. Therefore, our public shareholders may have more difficulty protecting their interests in the face of actions by our management, directors or controlling shareholders than would shareholders of a corporation incorporated in a jurisdiction in the United States. In addition, Cayman Islands companies may not have standing to initiate a shareholder derivative action before the federal courts of the United States.

It may be difficult for you to enforce any judgment obtained in the United States against our company, which may limit the remedies otherwise available to our shareholders.

Substantially all of our assets are located outside the United States. Almost all of our current operations are conducted in China. Moreover, a number of our directors and officers are nationals or residents of countries other than the United States. All or a substantial portion of the assets of these persons are located outside the United States. As a result, it may be difficult for you to effect service of process within the United States upon these persons. In addition, there is uncertainty as to whether the courts of the Cayman Islands or China would recognize or enforce judgments of United States courts obtained against us or such persons predicated upon the civil liability provisions of the securities law of the United States or any state thereof, or be competent to hear original actions brought in the Cayman Islands or China, respectively, against us or such persons predicated upon the securities laws of the United States or any state thereof. See Item 4 Information on the Company Business Overview Enforceability of Civil Liabilities.

Item 4. Information on the Company

History and Development of the Company

We were established as an exempted company under the laws of the Cayman Islands on April 3, 2000. Our legal name is Semiconductor Manufacturing International Corporation. Our principal place of business is 18 Zhangjiang Road, Pudong New Area, Shanghai, China 201203, telephone number: (86) 21-5080-2000. Our registered agent is M&C Corporate Services Limited, located at P.O. Box 309 GT, Ugland House, South Church Street, George Town, Grand Cayman, Cayman Islands. Since our global offering, we have been listed on the New York Stock Exchange under the symbol SMI and the Stock Exchange of Hong Kong under the stock code 0981.

We were founded by Dr. Richard Ru Gin Chang, our Chief Executive Officer and President, who has more than 27 years of experience in the semiconductor industry. In August 2000, we started construction of the first fab in our Shanghai mega-fab. The first fab in the Shanghai mega-fab commenced pilot production in September 2001, and we achieved internal qualification of our 0.18 micron CMOS logic process at this fab in December 2001. That fab and the portion of our second fab in our Shanghai mega-fab which provides aluminum interconnects, commenced commercial production in January 2002. The portion of this second fab which provides copper interconnects and a third fab in our Shanghai mega-fab commenced commercial production in January 2003. All the fabs comprising the Shanghai mega-fab are located in the Zhangjiang High-Tech Park. In January 2004, we completed the acquisition of an 8-inch wafer fab located in the Xiqing Economic Development Area in Tianjin, China, and commenced mass production in May 2004. We commenced construction of our Beijing mega-fab in the Beijing Economic and Technological Development Area in December 2002. The Beijing mega-fab consists of three twelve-inch fabs, the first of which commenced commercial production in March 2005 and is China s first 12-inch fab.

We have entered into an agreement with Toppan Printing Co., Ltd., to establish Toppan SMIC Electronics (Shanghai) Co., Ltd., to manufacture color filters and micro-lenses for CMOS image sensors and a joint venture agreement with United Test and Assembly Center Ltd. to provide assembly and testing services in Chengdu focusing on memory and logic devices. We have also entered into agreements to manage the operations of wafer manufacturing facilities in Chengdu and Wuhan, China. We maintain customer service and marketing offices in Japan, Europe, and the United States and a representative office in Hong Kong.

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The foundry industry requires a significant amount of capital expenditures in order to construct, equip, and ramp up fabs. We incurred capital expenditures of US$492 million, US$2,000 million and US$903 million in 2003, 2004 and 2005, respectively, for these purposes. We anticipate that in 2006, we will incur US$1,100 million of capital expenditures, principally to expand our operations at our mega-fabs in Shanghai and Beijing and fab in Tianjin. If our operating cash flows are insufficient, we plan to fund the expected shortfall through bank loans. If necessary, we will also explore other forms of external financing.

Our fabs had an aggregate capacity, as of December 31, 2005, of 132,260 8-inch wafer equivalents per month for wafer fabrication and 19,959 wafers per month for copper interconnects. We anticipate that as of the end of 2006, we will have an aggregate capacity of 185,000 8-inch wafer equivalents per month.

For additional information, see Item 5 Operating and Financial Review and Prospects Factors that Impact Our Results of Operations Substantial Capital Expenditures and Capacity Expansion.

Business Overview

We are one of the leading semiconductor foundries in the world. We operate three 8-inch wafer fabrication facilities in our Shanghai mega-fab located in the Zhangjiang High-Tech Park in Shanghai, China, an 8-inch wafer fab in Tianjin, China and a 12-inch wafer fab in our Beijing mega-fab located in the Beijing Economic and Technological Development Area in Beijing, China. These fabs had an aggregate capacity as of December 31, 2005 of 132,260 8-inch wafer equivalents per month for wafer fabrication and 19,959 wafers per month for copper interconnects, which positions us as the leading foundry in China. In addition, we have constructed two additional 12-inch fabs for our Beijing mega-fab and are constructing an additional 12-inch fab for our Shanghai mega-fab. We have also entered into agreements to manage the operations of wafer manufacturing facilities in Chengdu and Wuhan, China. We also operate a fab at our Shanghai site which produces solar cells. Due to the unique nature of solar cells, this fab is not considered a part of our Shanghai mega-fab.

We currently provide semiconductor fabrication services using 0.35 micron to 90 nanometer process technology for the following devices:

- logic technologies, including standard logic, mixed-signal, RF and high voltage circuits;
- memory technologies, including DRAM, SRAM, Flash, and EEPROM; and
- specialty technologies, including LCoS, and CIS.

In addition to wafer fabrication, our service offerings include a comprehensive portfolio of intellectual property consisting of libraries and circuit design blocks, design support, mask-making, wafer probing, gold/solder bumping and redistribution layer manufacturing. We also work with our partners to provide assembly and testing services.

We have a global and diversified customer base that includes some of the world s leading IDMs and fabless semiconductor companies.

Our Industry

The Semiconductor Industry

Since the invention of the first semiconductor transistor in 1948, integrated circuits have become critical components in an increasingly broad range of electronics applications, including personal computers, wired and wireless communications equipment, televisions, consumer electronics and automotive and industrial control applications. Advancements in semiconductor design techniques and process technologies have allowed for the mass production of increasingly smaller and more powerful semiconductor devices at lower costs. This has resulted in the availability and proliferation of more complex integrated circuits with higher functionality. These integrated circuits may now each contain up to millions of transistors.

The key raw material for a semiconductor foundry is a raw wafer, which is a circular silicon plate. Raw wafers are available in different diameters (e.g., 5-inch, 6-inch, 8-inch or 12-inch) to meet the capabilities of different equipment. A fab capable of manufacturing integrated circuits on an 8-inch raw wafer is commonly described as an 8-inch fab. A raw wafer with a larger diameter has a greater surface area and

consequently yields a greater number of integrated circuit dies. One method that foundries attempt to use to maintain their competitiveness is to increase the diameter of the wafers they use in manufacturing, such as the recent trend toward developing 12-inch wafers, each of which has approximately 2.25 times the number of gross dies achievable on an 8-inch wafer. IC Insights estimates that foundries with 12-inch facilities are expected to realize economies of scale from the increased number of dies per wafer and yield a manufacturing cost savings of approximately 30% on a per square centimeter basis once they enter into volume production. In addition, since 12-inch fabs have been constructed more recently, the equipment used in these fabs permits smaller line-width process technologies to be utilized. However, this equipment is more expensive than equipment for the fabrication of 8-inch wafers as the market for this equipment is less mature with fewer suppliers and the technology involved is more complex.

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Process technologies are the set of specifications and parameters implemented for manufacturing the circuitry on integrated circuits. The transistor circuitry on an integrated circuit typically follows lines that are less than one micron wide (1/1,000,000 of a meter). The linewidths of the circuitry, or the minimum physical dimensions of the transistor gate of integrated circuits in production, is used as a general rule for classifying generations of process technology of integrated circuits. Progress in the advancement of the integrated circuit has been driven by the scaling, or downsizing, of its components, primarily the transistors. By systematically shrinking the size of the transistors, the number of allowable transistors per die increases, and thus the number of dies on a given wafer, has also increased. Our current process technology ranges from 0.35 micron to 90 nanometer.

Importance of Integrated Circuits for China s Domestic Market and China s Emergence as a Global Electronics Manufacturing Center

China has emerged as a global manufacturing center for electronic products that are sold both within China and abroad. In recent years, numerous international companies have established facilities in China for the manufacture of a variety of electronic products, including household appliances, computers, mobile phones, telecommunications equipment, digital consumer products and products with industrial applications. An increasing number of electronic systems manufacturers, such as Flextronics and Solectron, are relocating production facilities from the United States, Taiwan, Southeast Asia and Mexico to China. China is establishing itself as a favorable manufacturing location due to its well educated labor force, significantly lower costs of operations, large domestic market for semiconductors and cultural similarities and geographical proximity to Japan, Hong Kong, Taiwan, Singapore and Korea, among other factors. According to International Finance Corporation, the private investment arm of the World Bank, US$46 billion, or 77%, of emerging markets production growth through 2005 will be attributable to China, at which point China would become the world s third largest manufacturing region behind North America and Japan. Such production growth represents additional potential demand for semiconductors manufactured in China. We believe that these electronics manufacturers will be likely to source a greater portion of their demand for integrated circuits from domestic integrated circuit suppliers in order to reduce production cycle time, lower costs, simplify supply chain logistics and meet local content requirements.

Increasing Importance of the Semiconductor Foundry Industry

As the cost of establishing new fabrication capacity has continued to rise, foundries have progressed from simply providing manufacturing capacity to becoming key strategic partners offering research and development capabilities and manufacturing process technologies. There have historically been a limited number of semiconductor foundries in the industry due to the high barriers to entry, which include significant capital commitments, scarcity of qualified engineers and advanced intellectual property and technology requirements. Many IDMs, such as Elpida, Infineon and Texas Instruments, have begun outsourcing their fabrication requirements for complex and high performance semiconductor devices to foundries in order to supplement their own internal capacities and become more cost competitive. In addition, fabless semiconductor companies have shifted from relying on the excess fabrication capacity of IDMs to utilizing independent foundries to meet the majority of their wafer production needs. We believe that we are well positioned to benefit from the growth of fabless semiconductor companies and the increase in outsourcing by IDMs, particularly because our facilities are equipped to manufacture integrated circuits using leading edge technologies at competitive costs.

The increasing trend in IDM outsourcing and the further development of fabless semiconductor companies are the two key drivers for the growth of the foundry industry, which is expected to significantly outpace the growth of the overall semiconductor industry. According to IC Insights, the size of the foundry industry in terms of worldwide sales reached US$16.5 billion in 2005, representing a 20.5% compound annual growth rate from US$5.5 billion in 1998, and is projected to reach US$39.5 billion by 2008, representing a compound annual growth rate of 21.8% since 1998. In contrast, the overall semiconductor industry is expected to grow at a compound annual rate of 9.5% over the same time period.

Our Strategy

Our goal is to maintain our position as one of the leading semiconductor foundries in the world. We plan to continue to offer our services to leading semiconductor suppliers worldwide while maintaining our leadership position in China. The key elements of our strategy include the following:

Capitalize on Our Early Mover Advantage to Capture Semiconductor Industry Growth Opportunities in China

We are a leader and an early mover in the advanced semiconductor foundry industry in China. According to the China Center for Information Industry Development, there are over 500 fabless semiconductor companies and design centers in China. The majority of these potential customers are located around the Greater Shanghai and Beijing metropolitan areas in the vicinity of our existing fabs. Most of these domestic fabless companies focus on the design of integrated circuits in an attempt to meet the needs of domestic market demand in terms of features and functionality. We believe that as the fabless integrated circuit industry in China matures, there will be an increased demand for foundry services

in China. We are committed to offering customers best-in-class services and solutions that are customized for their particular technological capabilities and financial resources. We have already established foundry relationships with a significant number of leading local fabless semiconductor companies in China. We believe that by establishing our company as a key foundry partner to local semiconductor companies at an early stage of their development, we will be well positioned to take advantage of the potential semiconductor industry growth in China.

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Currently, we believe we have the largest installed 8-inch wafer fabrication capacity and the only 12-inch wafer fabrication capacity in China. Our location in China allows us to develop close relationships with the increasing number of IDMs and systems companies that are, or whose customers are, moving their existing manufacturing facilities to, or establishing new facilities in, China. Similar to our strategy regarding fabless semiconductor companies, we believe our close proximity to these IDMs and systems companies will allow us to form close alliances with them to meet the growing demand for electronic devices both within China and around the world.

Target a Diversified and Global Customer Base

We have a global customer base consisting of leading IDMs, fabless semiconductor companies, and systems and other companies. We believe these customers have high growth potential and business plans that are directed towards utilizing our manufacturing services and solutions. In order to maximize the utilization of our fabs and optimize our process technology offerings, we plan to focus on attracting potential customers with advanced design capabilities that require leading edge foundry services in high volumes. The semiconductor industry is developing rapidly and demand for products associated with different applications and technical standards continues to grow. We intend to maintain a diversified customer mix in terms of end-market applications, processes and geographical focus in order to manage our exposure to each market segment.

Maintain Leading Edge Technology and Innovation through Internal Research and Development and Strategic Alliances and Partnerships

In order to serve our customers diverse needs, we intend to continue to expand our portfolio of leading edge process technology capabilities in logic, mixed signal, RF, memory and specialty semiconductor devices. An expanded portfolio of process technologies is a key factor in being able to produce a wide spectrum of semiconductor devices while minimizing production volume fluctuations. To achieve this strategic goal in technology and innovation, we rely on our internal research and development team, as well as our leading global technology partners. This two-pronged strategy allows us to shorten the development cycle and provide our customers with quality manufacturing capabilities while also sharing development costs with other parties. As a result, we were, for example, among the first foundries to offer customers the option of outsourcing their 0.13 micron copper interconnects.

We have established partnerships with leading semiconductor companies and research institutes, such as Fujitsu Limited, Infineon Technologies AG, Interuniversitair Micro-Elektronica Centrum vzw, or IMEC, Freescale Semiconductor Inc., or Freescale, Elpida, and Toshiba, and intend to continue to maintain and broaden our list of technology partners. Our partnerships with leading semiconductor companies have not only provided us with access to a diverse portfolio of technologies, but have also helped to strengthen our relationships with these companies, some of which are our customers. We believe our relationships with these customers have, in turn, helped us establish credibility in the market and attract new customers.

Provide High Quality Customer Service

We believe that our focus on offering high quality customer service is an important factor in attracting and retaining leading semiconductor companies as our customers, and has been a key contributor to our growth. We have established a strong customer- and teamwork-oriented culture that focuses on maintaining close interactions with our customers at multiple levels and functional areas within our organization. The key areas of our customer service are:

- responsiveness to customers requirements in terms of lead times and product cycle time;
- flexibility in providing customized solutions and in production scheduling;
- timely delivery of products in the required volumes;
- strict adherence to high quality technical specifications;
- confidentiality and protection of customer intellectual property and proprietary information;

cost effectiveness;

real time online information; and

integrated 24-hour customer support.

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Shift Product Mix to Logic Wafers While Maintaining Expertise in DRAM Technology

We believe we are the only foundry among our key competitors to have adopted the strategy of offering leading edge technology for both DRAM and logic semiconductors. We believe our strategy of maintaining core competency in manufacturing both logic and DRAM semiconductors is particularly important in the development of system-on-chip product technology. We have historically utilized a relatively high percentage of our total capacity for the production of DRAM wafers for shipment to certain of our strategic partners on a foundry basis and for sale to our distributors. DRAM wafers produced for sale to our distributors are essentially commodity-type DRAM wafers we manufacture on spec without a purchase order or a specific customer in mind. These wafers are sold into the market to various customers through our distributors.

Through the production of DRAM wafers, we have been able to quickly ramp up our production facilities, debug our production processes and equipment, and train our personnel in a high volume, advanced process fabrication environment. We will continue to manufacture DRAM wafers for our customers on a foundry basis and expect that our production of DRAM wafers on spec will decrease. At the same time, we have increased and intend to continue increasing, the relative production volume of logic wafers since these products generally have more stable prices and margins than commodity-type DRAM. As a result, we expect that our production of DRAM wafers as a percentage of overall production will decrease.

Our Fabs

We have implemented a One Mega Fab project to align the capabilities of our Shanghai fabs and of our Beijing fabs by standardizing our equipment and processes. As a mega-fab, a wafer produced at any of our fabs at one location should have statistically the same wafer acceptance test results and wafer yields as a semiconductor wafer produced at any of our other fabs that are producing the same product at that same location. This increases the flexibility of our total capacity and allows us to avoid costs and delays related to additional customer qualifications when we shift production from one fab to another.

The table below sets forth a summary of our current fabs and fabs under construction:

	Shanghai Mega-Fab	**Beijing Mega-Fab**	**Tianjin**
Number and Type of fab	8-inch fabs: Three in production 12-inch fab: One under construction	12-inch fabs: One in production, two additional fabs to be equipped	8-inch fab: One in production
Pilot production commencement	September 2001	July 2004	February 2004
Commercial production commencement	January 2002	March 2005	May 2004
Wafer size	8-inch 12-inch (under construction)	12-inch	8-inch
Production clean room size	23,310 m^2	17,945 m^2	8,463 m^2

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In addition to our Shanghai mega-fab, we have two additional fabs at our Shanghai site. A portion of one facility in Shanghai is being leased to Toppan SMIC Electronics (Shanghai) Co., Ltd., which manufactures color filters and micro-lenses for CMOS image sensors. The other fab in Shanghai manufactures solar cells. Most of the administrative and management functions of our fabs are centralized at our corporate headquarters in the Zhangjiang High-Tech Park in the Pudong New Area of Shanghai.

Our fabs are organized into bays grouped by function. The general production environment consists of class 1000 or class 100 clean rooms. Within the larger clean rooms, the actual fabrication steps are performed in a class 1 clean standard mechanical interface box, within which the wafers are also transferred between each step in the fabrication process. The use of these boxes and other mini-environments results in reductions of building structure costs, mechanical and electrical system requirements and operating costs, allows flexibility with respect to the layout and reconfiguration of equipment and facilitates the ramping-up process during capacity expansions.

Management of Fabs

We also have undertaken agreements relating to wafer manufacturing facilities in Chengdu and Wuhan, China. Under these agreements, we will not invest any money to construct or equip the wafer manufacturing facilities but will manage the operations, including the wafer loadings, of the facilities.

Our Services

Wafer Fabrication Services

We currently provide semiconductor fabrication services using 0.35 micron to 90 nanometer technology for the following devices:

- logic technologies, including standard logic, mixed-signal, RF and high voltage circuits;
- memory technologies, including DRAM, SRAM, Flash, EEPROM and Mask ROM; and
- specialty technologies, including LCoS, and CIS.

These semiconductors are used in various computing, communications, consumer and industrial applications, such as computers, mobile telephones, digital televisions, digital cameras, DVD players, entertainment devices, other consumer electronics devices and automotive and industrial applications.

We believe we are one of the few foundries in the world to offer copper interconnects technologies to our global customers. We believe we are also the first foundry in China to introduce copper technology on a 0.13 micron production line. The capacity for our copper interconnects line was 19,959 wafers per month as of December 31, 2005.

Our Technologies

We manufacture the following types of semiconductors:

Logic Semiconductors. Logic semiconductors process digital data to control the operation of electronic systems. The largest segment of the logic market, standard logic devices, includes microprocessors, microcontrollers, DSPs and graphic chips. Logic semiconductors are used in communications devices, computers and consumer products, with the most advanced logic semiconductors dedicated primarily to computing applications.

Mixed-Signal and RF. Analog/digital semiconductors combine analog and digital devices on a single semiconductor to process both analog signals and digital data. We make 0.35 micron to 0.13 micron mixed-signal and RF semiconductors using the CMOS process.

The primary uses of mixed-signal semiconductors are in hard disk drives, wireless communications equipment and network communications equipment, while RF semiconductors are primarily used in communications devices, such as cell phones.

High Voltage. High voltage semiconductors are semiconductor devices that can drive high voltage electricity to systems that require voltage of between five volts to several hundred volts. Our high voltage technologies provide solutions for display driver integrated circuits, power supplies, power management, telecommunications, automotive electronics and industrial controls.

Memory Semiconductors. Memory semiconductors, which are used in electronic systems to store data and program instructions, are generally classified as either volatile memory, which lose their data content when power supplies are switched off, or non-volatile memory, which retain their data content without the need for a constant power supply. Examples of volatile memory include SRAM and DRAM, and examples of non-volatile memory include electrically erasable programmable read-only memory, or EEPROM, NAND Flash and OTP. Memory semiconductors are used in communications devices, computers and many consumer products.

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Specialty Semiconductors.

LCoS. LCoS microdisplays are tiny, high resolution, low power displays designed for high definition televisions, projectors and other products that use or rely on displays. Compared with other display technologies, such as liquid crystal and plasma, LCoS displays have higher resolution and higher fill factor, resulting in superior images, colors and performance. LCoS process technology represents an enhancement of mixed-signal CMOS process technology with the addition of a highly reflective mirror layer.

CIS. CIS devices are sensors that are used in a wide range of camera-related systems, such as digital cameras, digital video cameras, handset cameras, personal computer cameras and surveillance cameras, which integrate image-capturing capabilities onto a chip. CIS is rapidly becoming a cost-effective and low power replacement for competing charged-coupled devices, or CCDs. Since CIS devices are fabricated with CMOS technology, they are easier to produce and more cost-effective than CCDs. By combining camera functions on a chip, from the capture of photos to the output of digital bits, CMOS image sensors reduce the parts required for a digital camera system, which in turn enhances reliability, facilitates miniaturization, and enables on-chip programming. Our CIS process is based on our CIS array technology.

We are one of the leading foundries in the world in terms of the process technologies that we are capable of using in the manufacturing of semiconductors: 40.6% of our wafer sales in 2005 were from products that utilized advanced technology of 0.13 micron and below.

The following table sets forth the actual and projected range of process technology capabilities of our fabs:

	Month and year of commencement of commercial production of	**Process technology (in microns)**			
Fab	**initial fab**	**2003**	**2004**	**2005**	**2006**
Wafer fabrication :					
Shanghai Mega-fab	January 2002	0.35/0.25/ 0.18/0.15/0.13	0.35/0.25/ 0.18/0.15/ 0.13/0.11	0.35/0.25/ 0.18/0.15/ 0.13/0.11/0.09	0.35/0.25/ 0.18/0.15/ 0.13/0.11/0.09
Beijing Mega-fab	March 2005		0.15/0.13/0.10	0.15/0.13/0.11/ 0.10/0.09	0.15/0.13/0.11/ 0.10/0.09
Tianjin fab	May 2004			0.35/0.18[(3)]	0.35/0.25/ 0.18/0.15
Metal Interconnects (aluminum and copper):					
Shanghai mega-fab Aluminum	January 2002	0.35/0.25/ 0.18/0.15	0.35/0.25/ 0.18/0.15/0.13	0.35/0.25/ 0.18/0.15/0.11	0.35/0.25/ 0.18/0.15/0.11
Shanghai mega-fab Copper	January 2002	0.13	0.13	0.13	0.13/0.09
Beijing mega-fab Copper	Second half of 2006				0.13/0.09

The following table sets forth a percentage breakdown of wafer sales by process technology for the years ended December 31, 2003, 2004, and 2005 and each of the quarters in the year ended December 31, 2005:

Process Technologies	For the year ended December 31, 2003	2004	March 31, 2005	For the three months ended June 30, 2005	September 30, 2005	December 31, 2005	For the year ended December 31, 2005
				(based on sales in US$)			
0.13 micron	11.8%	11.7%	29.2%	44.5%	43.8%	42.9%	40.6%
0.15 micron	9.9%	14.2%	12.5%	2.5%	2.7%	5.2%	5.4%
0.18 micron	22.0%	42.6%	40.3%	40.7%	45.3%	42.3%	42.3%
0.25 micron	34.5%	7.1%	4.6%	3.9%	3.1%	3.3%	3.7%
0.35 micron	21.8%	24.4%	13.4%	8.4%	5.1%	6.3%	8.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

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Technology Partners

Our technology partners have licensed to us leading process technology and design intellectual property. Our technology partners include the following:

- Chartered Semiconductor for 0.18 micron logic;
- Fujitsu Limited for 0.22 micron DRAM and 0.18 micron FCRAM;
- Infineon Technologies AG for 0.14 micron and 0.11 micron DRAM;
- Elpida Memory, Inc. for 0.10 micron and 90 nanometer DRAM; and
- Toshiba for 0.21 micron and 0.15 micron SRAM.

One of these technology partners, specifically Infineon Technologies AG, is among our five largest customers in 2005.

Our other technology partners include ARM Limited, IMEC, Freescale, VeriSilicon Holdings, Ltd. and Virage Logic Corporation. Some of these technology arrangements involve corresponding foundry or supply agreements in which we agree to guarantee a minimum capacity for the fabrication of specific products for these technology partners. Certain of our technology partners only allow us to use their technology to manufacture wafers for them.

Manufacturing Capacity

We currently manufacture 8-inch silicon wafers based on proprietary designs provided by our customers or third party designers. Since commencing commercial production, we believe we have the largest 8-inch wafer fabrication capacity among the semiconductor foundries in China. We believe we have the most advanced process technology among foundries in China and were the first fab to use 0.18 micron process technology. In January 2003, we commenced commercial production using 0.13 micron copper interconnects process technology. We believe we are currently the only fab in China to offer 0.13 micron copper interconnects process technology and 90 nanometer wafer fabrication process technology.

The following table sets forth the historical capacity of our wafer fabrication and copper interconnects fabs as of December 31, 2005:

Fab	2003	2004	2005
Wafer Fabrication:			
Wafer fabrication capacity as of year-end[(1)]:			
Shanghai mega-fab	49,000	81,406	89,892
Beijing mega-fab		7,027	27,368
Tianjin fab		14,182	15,000
Total monthly wafer fabrication capacity as of year-end[(1)]	49,000	102,615	132,260
Wafer fabrication capacity utilization	94%	98%	89%
Copper Interconnects:			
Copper interconnects capacity as of year-end[(1)]:			
Shanghai mega-fab[(2)]	9,000	17,802	19,959

(1) All output and capacity data is provided as 8-inch wafers or 8-inch wafer equivalents per month. Conversion of 12-inch wafers to 8-inch wafer equivalents is achieved by multiplying the number of 12-inch wafers by 2.25.

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(2) Reflects wafers fabricated using the copper interconnects line and does not include wafers fabricated using the aluminum interconnects line. As a small number of wafers produced by our aluminum interconnects lines also utilize the copper interconnects capabilities, our reported capacity and output data for our copper interconnects line overlaps to a limited extent with such data for our aluminum interconnects lines.

As of December 31, 2005, our aggregate wafer fabrication capacity was 132,260 8-inch wafer equivalents per month for wafer fabrication and 19,959 wafers per month for copper interconnects.

A key factor influencing our profit margins is our capacity utilization. Because a high percentage of our cost of sales is of a fixed nature, operations at or near full capacity have a significant positive effect on output and profitability. In both 2002 and 2003, our wafer fabs had an average annual utilization rate of 94%, in 2004, our wafer fabs had an average annual utilization rate of 98%, and in 2005, our wafer fabs had an average annual utilization rate of 89%. Factors affecting utilization rates include our ability to manage the production facilities and product flows efficiently, the percentage line yield of wafers during the fabrication process, the complexity of the wafer produced, and the actual product mix. In addition, we have manufactured DRAM to fill our production lines when the volume demand of other products does not fully utilize our available capacity. As a result, our utilization rate has historically remained high.

We determine the capacity of a fab based on the capacity ratings given by manufacturers of the equipment used in the fab, adjusted for, among other factors, actual output during uninterrupted trial runs, expected down time due to setup for production runs and approximately one to two days of scheduled annual maintenance, and expected product mix. All of our fabs currently operate 24 hours per day, seven days per week, except during periods of annual maintenance. Employees in our fabs work shifts of 12 hours each day on a two-days-on, two-days-off basis.

We have often used DRAM as the initial product to test the production capabilities at a new fab. This is because DRAM requires higher process accuracy, more precise process control and a higher degree of engineering skills and operational disciplines, and can therefore assist in early identification of any potential process, equipment or fab-related production problems. This DRAM is either manufactured on a foundry basis for our customers or sold by us to the market through our distributors under technology licensing and royalty arrangements. However, the market for DRAM devices has also been more volatile and susceptible to sudden price drops in recent years. We expect that our production of DRAM wafers as a percentage of our overall production will decrease. For our new wafer fabs, we anticipate using logic products as the initial product to test the wafer fab s production capacity.

Capacity Expansion Plans

We intend to maintain our strategy of expanding capacity and improving our process technology to meet both the capacity requirements and the technological needs of our customers. Our capital expenditures in 2004 were approximately US$2,000 million and our capital expenditures in 2005 were approximately US$903 million. We currently expect that our capital expenditures in 2006 will be approximately US$1,100 million, which we plan to fund through our operating cash flows and bank loans. If necessary, we will also explore other forms of external financing. We plan to use this capital primarily to expand our operations at our mega-fabs in Shanghai and Beijing and fab in Tianjin. In addition, our actual expenditures may exceed our planned expenditures for a variety of reasons, including changes in our business plan, our process technology, market conditions, equipment prices, customer requirements or interest rates. We will monitor the global economy, the semiconductor industry, the demands of our customers, and our cash flow from operations to adjust our capital expenditure plans.

We also will seek to participate in strategic partnerships to meet the demands of our customers. For example, in July 2004, we entered into an agreement with Toppan Printing Co., Ltd., to establish Toppan SMIC Electronics (Shanghai) Co., Ltd., a joint venture in Shanghai, for the manufacture of color filters and micro-lenses for CMOS image sensors. These products are increasingly being used in consumer products such as mobile phone cameras, digital cameras and automobile and home security applications. Toppan SMIC Electronics (Shanghai) Co., Ltd. commenced pilot production in December 2005. We hold a 30% equity interest in Toppan SMIC Electronics (Shanghai) Co., Ltd.

Management of Fabs

We also have undertaken agreements relating to wafer manufacturing facilities in Chengdu and Wuhan, China. Under these agreements, we will not invest any money to construct or equip the wafer manufacturing facilities but will manage the operations, including the wafer loadings, of the facilities.

Our Integrated Solutions

In addition to wafer fabrication, we provide our customers with a range of complementary services, from circuit design support and mask-making to wafer level probing and testing. This range of services is supported by our network of partners that assist in providing design, probing, final testing, packaging, assembly and distribution services. Our main goal in the provision of these services is to help our customers

achieve higher performance products and greater yield in the most cost-effective and timely manner. Because of our ability to provide an array of services in addition to wafer fabrication, we are able to accommodate customers with a

variety of needs. Many of our customers choose to have us make the masks to be used during the fabrication process, as this decreases the risk of damage to the masks that can result from having to transport them. The flexibility in input stages allows us to cater to a variety of customers with different in-house capabilities and thus to service a wider class of customers as compared to a foundry that cannot offer design support or mask-making services.

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The diagram below sets forth our service model and our key points of interaction with our customers:

(1) A portion of this work is outsourced to our service partners.
(2) All of these services are outsourced to our service partners.

Design Support Services

Our design support services include providing our customers with access to the fundamental technology files and intellectual property libraries that facilitate customers own integrated circuit design. We also offer design reference flows and access to our design center alliance, as well as layout services. In addition, we collaborate with industry leaders in electronic design automation, library and intellectual property services to create a worldwide network of expertise, resources and services that are available to implement and produce a customer s designs. As of December 31, 2005, we employed over 191 engineers devoted solely to design support services.

Libraries

As part of the necessary building blocks for our customers semiconductor designs, we offer libraries of compatible designs for portions of semiconductors, such as standard cells, I/O and selected memory blocks, in addition to technology files. We have a dedicated team of engineers who work with our research and development department to develop, license or acquire from third parties selected key libraries early on in the development of new process technologies so that our customers can quickly design sophisticated integrated circuits that utilize the new process technologies. We also have arrangements with other providers of libraries to provide our customers with access to a broad library portfolio for their designs. In particular, we offer a portfolio of ASIC library and design kits for a wide range of tested and verified circuit applications and design-flow implementation. These include standard cell, I/O and memory compilers in 0.35 micron, 0.25 micron, 0.18 micron, 0.15 micron, and 0.13 micron process technologies. They have been developed primarily through our third party alliances, as well as by our internal research and development team, to facilitate easy design reuse and fast integration into the overall design system. We are currently developing additional libraries. Our library partners include ARM, Synopsys, Inc., VeriSilicon, and Virage Logic.

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Intellectual Property

As semiconductors grow in complexity and time-to-market pressures mount, the intellectual property designs that we offer can assist our customers to attain faster cycle times. Together with the intellectual property developed by our internal design team, our alliances with intellectual property providers enable us to offer foundational designs ranging from 0.35 micron to 0.13 micron and relating to mixed-signal, embedded memory, high-speed interface, digital peripheral device controllers and embedded processors, among others. We use our own and third party design expertise to realize the functions of these various types of intellectual property. Our intellectual property partners include Aplus, ARM and Mosys, Inc.

Design Reference Flows

Customers implementing designs on our processes can utilize our design reference flows to achieve a smooth process from semiconductor design to production. These flows have been created using design tools developed by our electronic design automation partners, including Cadence Design Systems, Inc., Magma Design Automation, Inc., Mentor Graphics Corporation, and Synopsys, Inc. These methodologies are designed to shorten time-to-market. They include training guides and sample test cases to provide a step-by-step explanation on how the hierarchical design flow works.

Design Center Alliance

If a customer requires assistance in designing its semiconductors, we are able to recommend design partners from among our extensive design services network. This network consists of design companies that we have successfully worked with in the past, thereby helping to improve coordination and expedite the design process. If required, we are also able to offer our own internal design team members to help our clients to complete their designs.

Mask-making Services

We believe we are currently the most advanced mask supplier in China and are one of the few foundries in the world to offer in-house mask-making services. Many of our foundry customers utilize our mask-making services. We believe that having our own mask facility ensures a seamless flow of service from design to mask to wafer. This in-house capability facilitates the interaction of our mask and wafer engineers, thereby optimizing photo mask specifications for the achievement of high yield and quality and minimal cycle times. We believe this capability results in cost reductions for our customers and enables them to shorten their time-to-market.

While most of our mask-making services are for customers that also utilize our wafer fabrication services as part of our overall foundry service, we also produce masks for other domestic and overseas fabs as a separate revenue-generating service. For 2005, our management estimates that these mask-only customers constituted approximately 30% of our mask-related business. Our mask shop also cooperates with our research and development department to develop new technologies and designs.

Our mask-making facility, which is located in Shanghai, includes a 3,750 square meters clean room with up to class I specifications. It is designed for flexible expansion and is equipped with advanced equipment. We believe that much of this equipment is the most advanced in the world. At present, our mask shop offers both five-inch by five-inch and six-inch by six-inch reticles. Our facility is capable of producing binary masks, optical proximity correction masks and phase shift masks. Our mask facility also offers mask repair services. As of December 31, 2005, we had 157 personnel employed in our mask shop.

We also offer a multi-project wafer service that allows the cost of manufacturing one mask set to be shared among several customers. See Customers and Markets for more details regarding this service.

Intellectual property protection is a key focus of our mask-making services. See Intellectual Property for more details regarding the intellectual property protection measures we have instituted in our mask facility.

Wafer Probing, Assembly and Testing Services

We have our own probing facilities in Shanghai and Beijing that provide test program development, probe card fabrication, wafer probing, failure analysis, and failure testing. We also outsource these services to our partners for those customers that request them.

Our probing facility in Shanghai occupies a clean room space of 3,000 square meters, and our probing facility in Beijing occupies a clean room space of 1,400 square meters. Both facilities are rated at class 1,000 cleanliness and are equipped with advanced testers, probers and laser repair machines for logic, memory, and mixed-signal products. The probing facility in Beijing supports testing of Beijing s 12-inch wafers and Tianjin s 8-inch wafers. We estimate that these facilities current aggregate capacity for the probing of memory and logic devices is 65,500 wafers per month. We employ more than 190 personnel to provide these probing services. We have testing equipment for memory, logic and mixed signal applications, including some equipment that has been consigned to our Shanghai facility by our customers. This consigned testing equipment has been specially designed and built by our customers in order to probe their particular products at our facility.

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Our facility with United Test and Assembly Center Ltd. is located in Chengdu, China and provides both assembly and testing services for 8-inch and 12-inch wafers. This facility focuses on memory and logic devices. Our facility in Chengdu occupies a total area of 215,000 square meters. Construction area is 40,668 square meters, including approximately 11,000 square meters of clean room area. This facility commenced commercial production in the first quarter of 2006.

We have also established a network of partners that provide additional probing services, as well as assembly and testing services, for our customers that request these additional services. We have relationships with assembly and testing partners, including Amkor Assembly & Test (Shanghai) Co., Ltd. and ST Assembly Test Services Ltd., which have helped to enhance the range of services that we are able to offer our customers. We estimate that as of December 31, 2005, approximately 50% of the wafers we fabricated were probed at our in-house probing facility, with the remainder being outsourced to our partners.

Customers and Markets

Our customers include IDMs, fabless semiconductor companies and systems companies. The following table sets forth the breakdown of our sales by customer type for 2003, 2004 and 2005:

	For the year ended December 31,					
	2003		2004		2005	
Customer Type	**Sales**	**Percentage**	**Sales**	**Percentage**	**Sales**	**Percentage**
	(in US$ thousands, except percentages)					
Fabless semiconductor companies	$ 125,416	34.3%	$ 391,788	40.2%	$ 515,437	44.0%
Integrated device manufacturers	169,329	46.3%	515,282	52.9%	613,869	52.4%
Systems companies and others	71,079	19.4%	67,594	6.9%	42,013	3.6%
Total	$ 365,824	100.0%	$ 974,664	100.0%	$ 1,171,319	100.0%

We categorize our sales geographically based on the headquarters of the customer that issues the purchase order. The following table sets forth the geographical distribution of our sales and percentage of sales for 2003, 2004 and 2005:

	For the year ended December 31,					
	2003		2004		2005	
Region	**Sales**	**Percentage**	**Sales**	**Percentage**	**Sales**	**Percentage**
	(in US$ thousands, except percentages)					
United States	$ 134,080	36.7%	$ 391,433	40.2%	$ 478,162	40.8%
Europe	40,251	11.0%	125,596	12.9%	316,576	27.0%
Asia Pacific (excluding Japan and Taiwan[(1)]	52,691	14.4%	201,882	20.7%	175,846	15.0%
Taiwan	97,820	26.7%	120,652	12.3%	138,154	11.8%
Japan	40,982	11.2%	135,101	13.9%	62,581	5.4%
Total	$ 365,824	100.0%	$ 974,664	100.0%	$ 1,171,319	100.0%

(1) We believe a significant portion of the semiconductors ordered from customers headquartered in China are eventually exported as components in electronic products assembled in China.

We have a global and diversified customer base that includes IDMs, namely Fujitsu Limited, Infineon Technologies AG, Samsung Electronics Co., Ltd., STMicroelectronics Pte. Ltd. and Texas Instruments Incorporated, and fabless semiconductor companies, namely Broadcom Corporation, Elite Semiconductor Memory Technology Inc., and Marvell Semiconductor, Inc. The foregoing is not intended to identify our top customers, but rather to provide a representative sampling of our customer base. IDMs generally provide more stable and longer term purchase contracts, have higher order volumes, and license process technology to us. Although we are not dependent on any single customer, a significant portion of our sales is attributable to a relatively small number of our customers. Our sales could be significantly reduced if any of these customers cancels or reduces its orders, significantly changes its product delivery schedule or demands lower prices. In 2003, 2004 and 2005, our five largest customers accounted for approximately 57.0%, 59.1% and 64.0% of our sales, respectively. Our two largest customers in 2003,

Samsung Electronics and Texas Instruments, accounted for approximately 12.1% and 11.7% of our sales in that year, respectively. Our two largest customers in 2004, Broadcom and Fujitsu, accounted for approximately 13.4% and 12.7% of our sales in that year, respectively. Our two largest customers in 2005, Infineon and Broadcom, accounted for approximately 25.8% and 14.7% of our sales in that year, respectively.

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Our director, Lip-Bu Tan, is also a director of, and holds a shareholding interest of less than 1.0% in, ISSI, one of our five largest customers in 2003. In 2003, ISSI accounted for approximately 10.7% of our sales. In 2004, ISSI accounted for less than 6% of our sales. In 2005, ISSI accounted for 3.3% of our sales.

Our President and Chief Executive Officer, Richard Ru Gin Chang, and his wife together hold shareholding interests of less than 0.1% in one of our five largest customers in 2003, 2004 and 2005, Texas Instruments.

Our initial sales after commencing commercial operations in 2002 were mainly of DRAM that was fabricated and sold on a foundry basis, as well as commodity-type DRAM fabricated using technology licensed from Fujitsu and sold by us to distributors. This commodity-type DRAM was fabricated during our start-up phase in order to test and ramp up our facilities and train our personnel. As our business has grown and our fabs have matured, we have produced less commodity-type DRAM and more higher margin logic and advanced memory products. However, we intend to continue to produce commodity-type DRAM to maintain full utilization of our capacity.

The following table sets forth a breakdown of our sales by application type for 2003, 2004 and 2005:

	For the year ended December 31,					
	2003		2004		2005	
Application Type[1]	**Sales**	**Percentage**	**Sales**	**Percentage**	**Sales**	**Percentage**
	(in US$ thousands, except percentages)					
Computing	$ 139,375	38.1%	$ 231,235	23.7%	$ 423,163	36.1%
Communications	162,520	44.4%	551,635	56.6%	492,791	42.1%
Consumer	44,339	12.1%	138,314	14.2%	202,153	17.3%
Others	19,590	5.4%	53,480	5.5%	53,212	4.5%
Total	$ 365,824	100.0%	$ 974,664	100.0%	$ 1,171,319	100.0%

(1) Computing consists of integrated circuits such as hard disk drive controllers, DVD-ROM/CD-ROM driver integrated circuits, graphic processors and other components that are commonly used in personal digital assistants and desktop and notebook computers and peripherals. Communications consists of integrated circuits used in digital subscriber lines, digital signal processors, wireless LAN, LAN controllers, LCD drivers, handset components and caller ID devices. Consumer consists of integrated circuits used for DVD players, game consoles, digital cameras, smart cards and toys.

The following table sets forth a breakdown of our sales by service type for 2003, 2004 and 2005:

	For the year ended December 31,					
	2003		2004		2005	
Service Type	**Sales**	**Percentage**	**Sales**	**Percentage**	**Sales**	**Percentage**
	(in US$ thousands, except percentages)					
Fabrication of DRAM wafers	$ 139,553	38.1%	$ 193,950	19.9%	$ 384,587	32.8%
Fabrication of logic wafers[1]	209,914	57.4%	730,160	74.9%	739,296	63.1%
Other[2]	16,357	4.5%	50,554	5.2%	47,436	4.1%
Total	$ 365,824	100.0%	$ 974,664	100.0%	$ 1,171,319	100.0%

(1) Includes copper interconnects and memory devices whose manufacturing process is similar to that for a logic device.
(2) Includes mask-making and probing, etc.

We have customer service and marketing offices located in California, Milan, Shanghai, and Tokyo and a representative office in Hong Kong. Our Shanghai office serves China and other non-Japan Asian markets, our California office serves the North American market, and our Milan and Tokyo offices serve the European and Japanese markets, respectively. We also sell some products through sales agents in selected markets.

We believe that the most effective means of marketing our foundry services is by developing direct relationships with our customers. Our customer engineers work closely with our sales force by providing detailed technical advice and specifications to customers. We believe a significant portion of our business also arises through customer referrals. We believe that our focus on customer service has been an important factor in attracting leading semiconductor companies as customers. The key elements of our customer service are our customer-oriented culture, responsiveness, flexibility, and delivery accuracy. We offer the advantage of a short lead time and product cycle to customers who need finished products within a short time frame.

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We also provide our customers with the ability to share costs through our multi-project wafer processing shuttle service. This service allows customers to share costs with other customers by processing multiple designs on a single mask set. In addition to the significant cost savings, this shuttle service also provides fast turnaround time for customers that need to verify and/or redesign their products and allows us to perform low-volume test production runs for customers in the prototype stage. This service also helps to eliminate costly and time-consuming repetitive mask and wafer production runs, resulting in accelerated time-to-market for our customers.

We provide our customers with 24-hour online access to necessary information to conduct business with us. From our technical capabilities to a customer s order status, we provide an online solution for our customers. From wafer fabrication, wafer sorting and assembly to final testing and shipping, our data center electronically transfers data, work-in-progress tracking, yield/cycle-time reports, and quality/engineering data to customers.

Our sales cycle, meaning the time between our first contact with a customer in relation to a particular product and our first shipment of that product to the customer, typically lasts between three months to one year, depending on the type of process and product technology involved in the product we are requested to fabricate. Because of the fast-changing technology and functionality in integrated circuit design, foundry customers generally do not place purchase orders far in advance to fabricate a particular type of product. However, we engage in discussions with customers commencing in advance of the placement of purchase orders regarding customers expected fabrication requirements. See Risk Factors Risks Related to Our Financial Condition and Business Our sales cycles can be long, which could adversely affect our operating results and cause our income stream to be unpredictable.

See Item 5 Operating and Financial Review and Prospects Sales for a description of the seasonality of our business.

Research and Development

Our research and development activities are principally directed toward the development and implementation of more advanced and lower cost process technology. After giving effect to the reclassification, research and development expenses were US$34.9 million in 2003, US$74.1 million in 2004, and US$78.9 million in 2005, which represented 9.5%, 7.6%, and 6.7%, respectively, of our sales in those respective years. Our research and development costs include non-recurring engineering costs associated with the ramp-up of a new wafer facility. These research and development costs are subsequently classified in cost of sales upon commencement of commercial production at that particular wafer facility. We plan to continue to invest significant amounts in research and development in 2006 for our 65 nanometer manufacturing process. In order to increase the efficiency of our research and development efforts, we have formed separate logic and memory technology development centers.

We employ over 600 research and development personnel. This research and development team includes many experienced semiconductor engineers with advanced degrees from leading universities around the world, as well as top graduates from the leading universities in China. We believe this combination has enabled us to quickly bring our technology in line with the semiconductor industry technology roadmap and ensures that we will have skilled personnel to lead our technology advancement in the future.

Intellectual Property

While we continue to develop and patent our own technologies, we expect to have an ongoing need to obtain licenses for the proprietary technologies of third parties to enable us to manufacture certain advanced wafers for our customers. To date, we have been granted seventy-three patents, thirty-eight in Taiwan, eleven in the U.S., and twenty four in China, and have more than 450 patent applications pending in the United States, China and Taiwan. We believe our competitors and other industry participants have numerous patents concerning wafer fabrication and related technologies in multiple countries.

To obtain patent protection in Taiwan, an inventor must file an application with the Intellectual Property Office, which will subject the application to procedural and substantive reviews. If a patent application is preliminarily approved, it will be published in an official gazette for a three-month opposition period. If there are no oppositions or if the inventor is able to overcome opposition actions, then the patent will be granted. Assuming no opposition actions, the patent application process may be completed in approximately twelve to eighteen months. The validity period for the ten patents we have been granted is 20 years from the date the application is filed. As with patent rights in most other jurisdictions, a patentholder in Taiwan enjoys the exclusive right to exclude others from using, licensing, and otherwise exploiting the patent within Taiwan.

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We believe it is customary in the semiconductor industry for companies with large patent portfolios to have greater leverage in negotiating license arrangements with third parties due to their ability to offer cross-licensing arrangements. We believe that, to date, the disparity between our patent portfolio and the substantially larger portfolios of our competitors has not had a material impact on our ability to negotiate license arrangements on terms acceptable to us. For example, as a part of the settlement agreement of the patent infringement claims with TSMC, we and TSMC entered into a patent cross-license agreement under which each party will license the other party s patent portfolio through December 2010. However, in the future, we may not have the ability to negotiate license agreements on terms acceptable to us, and thus we may have to accept unfavorable and more costly licensing terms, which could adversely affect our margins, operating results, and competitiveness. If for any reason we are unable to license necessary technology on acceptable terms, it may become necessary for us to develop alternative technology internally, which could be costly and delay the marketing and delivery of key products and therefore have an adverse effect on our business and operating results. In addition, we may be unable to independently develop the technology required by our customers on a timely basis or at all, in which case our customers may purchase wafers from our competitors.

In order to minimize risks to us from any intellectual property infringement claims, we have implemented a screening procedure whereby customers are evaluated for infringement risk based on size, reputation and product specifications, and those that are identified as high-risk are examined closely for potential infringement. Some of our technology partners do not indemnify us for losses arising out of infringement of intellectual property rights relating to licensed-in processes they provide to us, but we are indemnified by most of our customers for losses arising out of infringement of intellectual property rights relating to the integrated circuit designs they provide to us.

We implement a variety of measures to protect the intellectual property and related interests of our company, customers and technology partners. We require our employees to execute a confidential information and invention assignment agreement relating to non-competition and intellectual property protection issues prior to commencing their employment at our company. Other measures include internal document and network control and a separate dedicated server for technical data. In our mask facility, we track all masks daily, delete all mask data after each project is completed and securely store all tapes and reticles. Access to customer information is granted to employees strictly on a need-to-know basis both during and after mask tooling.

We have applied for trademarks relating to our corporate logo and trade name SMIC in the United States, China, Hong Kong and Taiwan. We have been grated trademarks for our English trade name in China and Taiwan and our Chinese trade name in Hong Kong. There can be no assurance that other trademarks will be granted.

Competition

We compete internationally and domestically with dedicated foundry service providers, as well as with semiconductor companies that allocate a portion of their fabrication capacity to foundry operations. While the principal elements of competition in the wafer foundry market include technical competence, production speed and cycle time, time-to-market, research and development quality, available capacity, yields, customer service and price, we seek to compete on the basis of process technology capabilities, performance, quality and service, rather than solely on price. The level of competition differs according to the process technology involved. In more advanced technologies, the competition tends to be greater.

Our competitors and potential competitors include TSMC, UMC and Chartered Semiconductor. According to a leading IC industry market research company, TSMC, UMC and Chartered Semiconductor had market shares of approximately 44.8%, 15.4% and 6.2%, respectively, in the semiconductor foundry industry in 2005. We had a market share of approximately 6.4% in 2005, which represents a growth rate of approximately 20%, the highest growth rate among these foundries. TSMC has commenced commercial production at its fab in China, and UMC has established a relationship with a fab in commercial production in China. See Risk Factors Risks Related to Our Financial Condition and Business If we cannot compete successfully in our industry, particularly in China, our results of operations and financial condition will be adversely affected.

We believe we are the only emerging semiconductor foundry to have reached foundry capacity in excess of 125,000 8-inch wafers per month. We aim to use our competitive advantages of geographic location, scale, and technology partnerships to maintain and enhance our position in the global market.

Another group of potential competitors consists of IDMs that have established their own foundry capabilities. These include Fujitsu Limited, Hynix, MagnaChip, IBM, Samsung Electronics Co., Ltd. and Toshiba. IDMs are primarily dedicated to fabricating integrated circuits for the end products of their respective affiliates.

Quality and Reliability

We have implemented quality assurance measures relating to material quality control, monitoring of our in-line processes and wafer-level reliability control at every stage of our operations from technology development to production. By combining advanced quality assurance procedures and e-commerce technology, we monitor all processes, services and materials in our mask-making, wafer fabrication and probing facilities. These quality assurance measures include inspection of incoming materials, supplier and subcontractor management, manufacturing environmental control and monitoring, in-line defect monitoring, engineering change

control, calibration monitoring, chemical analysis and visual inspection. Quality assurance measures also include on-going process and product reliability monitors and failure tracking for early identification of production problems.

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As a result of these quality assurance measures, we have achieved a visual die defect rate that we believe is consistent with industry standards. We believe that wafers fabricated at our fabs provide consistently high die yield, which allows our customers to determine with greater certainty the appropriate number of wafers to order.

We incorporate reliability control in our entire production process and have adopted a system that enables us to track and record wafer-, package- and product-level reliability data throughout the development, qualification and production stages of the relevant process or device. This data enables us to identify problems at an early stage and provide an immediate diagnosis and solution, so as to further reduce our failure rate.

We achieved ISO 9001:2000 certification from the British Standards Institute with zero-defect performance for our Fab 1 in July 2002 and for our Fab 2 and Fab 3B in March 2003. The ISO 9001 quality standards were established by the International Standards Organization, an organization formed by delegates from member countries to establish international quality assurance standards for products and manufacturing processes. International Standards Organization certification is required in connection with sales of industrial products in many countries. To further enhance our quality management system, we obtained TS 16949:2002 certification from the British Standards Institute (BSI) in February 2004. This is an International Standards Organization quality management certification that relates to automobile applications and primarily measures a device s ability to handle extreme changes in temperature. In January 2005, we obtained TL9000 Quality Management System certification from BSI. This is a management certification relating to the telecommunications industry and evaluates research and development, production and installation and maintenance of communication product and services.

Raw Materials

Our fabrication processes use many raw materials, primarily silicon wafers, chemicals, gases, and various types of precious and other metals. Raw material costs constituted 21.7% of our cost of sales in 2003, 21.1% of our cost of sales in 2004 and 18.9% of our cost of sales in 2005. The three largest components of raw material costs raw wafers, chemicals and gases accounted for approximately 41%, 32% and 9%, respectively, of our raw material costs in 2003, approximately 41%, 20% and 11%, respectively, of our raw material costs in 2004 and approximately 42%, 22% and 11%, respectively, of our raw material costs in 2005. Most of our raw materials generally are available from several suppliers, but substantially all of our principal materials requirements must currently be sourced from outside China. Our raw material procurement policy is to select only those vendors who have demonstrated quality control and reliability with respect to delivery time and to maintain multiple sources for each raw material so that a quality or delivery problem with any one vendor will not adversely affect our operations. The quality and delivery performance of each vendor is evaluated on a quarterly basis and quantity allocations are adjusted for subsequent periods based on these evaluations and on the prices offered by these vendors. To date, we have not experienced any shortages in the supply of our raw materials, and we do not expect to experience any such shortages in the foreseeable future.

The most important raw material used in our production is silicon in the form of raw wafers. The principal suppliers of our raw wafers are Hong Kong Topco Scientific Co., Ltd., Komatsu Electronic Metals Co., Ltd. and MEMC Electronic Materials, Inc. In 2005, we purchased approximately 77% of our overall raw wafer requirements from these three raw wafer suppliers. We have in the past obtained sufficient quantities of 8-inch and 12-inch wafers and believe we will continue to be able to obtain a sufficient supply of 8-inch and 12-inch raw wafers.

For 2005, our largest and five largest raw materials suppliers accounted for approximately 14.0% and 43.5%, respectively, of our overall raw materials purchases. For 2004, our largest and five largest raw materials suppliers accounted for approximately 10.6% and 40.7%, respectively, of our overall raw materials purchases. For 2003, our largest and five largest raw materials suppliers accounted for approximately 12% and 46%, respectively, of our overall raw materials purchases. Having made all reasonable inquiry, we are not aware of any director or shareholder (which to the knowledge of our directors own more than 5% of our issued share capital) or their respective associates, which had shareholding interests in any of our five largest suppliers. Almost all of our materials are imported free of value-added tax and import duties due to concessions granted to our industry in China.

Electricity and Water

We use substantial amounts of electricity in our manufacturing process. This electricity is sourced for our three locations from the Pudong Electricity Corporation, the Beijing Municipal Electricity Department and the Tianjin Municipal Electricity Department. We enjoy a preferential electricity supply for our Shanghai fabs due to our location in the Zhangjiang High-Tech Park. We have not experienced any material disruptions in the electricity supply to any of our fabs to date, and also maintain emergency back-up generators to power safety and emergency systems.

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The semiconductor manufacturing process uses extensive amounts of fresh water. We source our fresh water for our Shanghai mega-fab from Pudong Vivendi Water Corporation Limited, for our Beijing mega-fab from Beijing Waterworks Group Co. Ltd. and for our Tianjin fab from the Tianjin Municipal Water Department. We believe these water supplies are adequate for our requirements and are not subject to any seasonal or periodic shortages. Because Beijing and Tianjin are subject to potential water shortages in the summer, our fabs in Beijing and Tianjin are equipped with back-up reservoirs. We have taken steps to reduce fresh water consumption in our fabs and capture rainwater for use at our Beijing facilities, and our water recycling systems in each of our fabs allow us to recycle 40% to 70% of the water used during the manufacturing process.

Regulation

Integrated circuit industry in China is subject to substantial regulation by the Chinese government. This section sets forth a summary of the most significant Chinese regulations that affect our business in China.

Scope of Regulation

The *Several Policies to Encourage the Development of Software and Integrated Circuit Industry*, or the Integrated Circuit Policies, promulgated by the State Council on June 24, 2000, together with other ancillary laws and regulations, regulate integrated circuit production enterprises, or ICPEs. The State Council issued the Integrated Circuit Policies in order to encourage the development of the software and integrated circuits industry in China. The Integrated Circuit Policies form the basis for a series of laws and regulations that set out in detail the preferential policies relating to ICPEs. Such laws and regulations include:

the *Notice of the Ministry of Finance, the State Administration of Taxation and the General Administration of Customs on Relevant Taxation Policy Issues Encouraging the Further Development of the Software Industry and the Integrated Circuit Industry,* or the Integrated Circuit Notice, jointly issued by the Ministry of Finance, the State Administration of Taxation and the General Administration of Customs on September 22, 2000, as amended by the *Notice of the Ministry of Finance and the State Administration of Taxation on Approval Procedure Concerning Implementing Enterprise Income Tax Policies of the Software and Integrated Circuit Industry on Foreign Invested Enterprises,* or the Approval Notice, jointly issued by the Ministry of Finance and the State Administration of Taxation on July 1, 2005;

the *Notice on Taxation Policies Encouraging the Further Development of the Software and the Integrated Circuit Industry*, or the Further Development Taxation Notice, jointly issued by the Ministry of Finance and the State Administration of Taxation on October 10, 2002, as amended by the *Notice on Termination of Value-added Tax Refund Policies for Integrated Circuits*, or the Termination Notice, jointly issued by the Ministry of Finance and the State Administration of Taxation on October 25, 2004;

the *Notice on Taxation Policies Concerning the Import of Raw Materials and Consumables Used for Production by Some Integrated Circuit Production Enterprises for Their Own Use*, or the Raw Materials Taxation Notice, issued by the Ministry of Finance on August 24, 2002;

the *Notice on Taxation Policies Concerning the Import of Construction Materials Specially used for Clean Rooms by Some Integrated Circuit Production Enterprises*, or the Construction Materials Taxation Notice, issued by the Ministry of Finance on September 26, 2002;

the *Notice by the Ministry of Finance and the State Administration of Taxation on Increasing Tax Refund Rate for Export of Certain Information Technology Products*, or the Export Notice, issued on December 10, 2004;

the *Measures for the Accreditation of the Integrated Circuit Enterprises Encouraged by the State (For Trial Implementation)*, or the Accreditation Measures, jointly issued by the National Development and Reform Commission, the Ministry of Information Industry, the State Administration of Taxation and the General Administration of Customs on October 21, 2005; and

the *Interim Measures for the Management of the Special Fund for the Research and Development of the Integrated Circuit Industries*, or the Fund Measures, jointly issued by the Ministry of Finance, the Ministry of Information Industry and the National Development and Reform Commission on March 23, 2005.

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Preferential Industrial Policies Relating to ICPEs

ICPEs duly accredited in accordance with relevant laws and regulations may qualify for preferential industrial policies. Under the Integrated Circuit Policies, accreditation of ICPEs is determined by the competent examination and approval authorities responsible for integrated circuit projects after consultation with relevant taxation authorities. Under the Accreditation Measures, an integrated circuit enterprise refers to an independent legal entity duly established in the PRC (except for Hong Kong, Macao and Taiwan) engaging in the fabrication, package, or testing of integrated circuit chips and the production of monocrystalline silicon of six inches or above, excluding the integrated circuit design enterprise. The accreditation of ICPEs is included in the accreditation of the integrated circuit enterprises. Such accreditation is determined by the competent authorities consisting of the National Development and Reform Commission, the Ministry of Information Industry, the State Administration of Taxation and the General Administration of Customs, which jointly designate the China Semiconductor Industrial Association as the accreditation institution. Any enterprise qualified under the requirements set forth in the Accreditation Measures is entitled to apply to the China Semiconductor Industrial Association for the accreditation of the ICPE. The accreditation of ICPEs is annually reviewed. If the enterprise fails to apply for the annual review in time, it shall be deemed as giving up such accreditation and if the enterprise fails in the annual review, the accreditation will also be canceled.

SMIC Shanghai, SMIC Beijing, and SMIC Tianjin have received accreditation as ICPEs entitling them to the preferential industrial policies described below.

Encouragement of Domestic Investment in ICPEs

Pursuant to the *Interim Provisions on Promoting Industrial Structure Adjustment,* or the Interim Provisions, issued by the State Council on December 2, 2005, and the *Catalogue for the Guidance of Industrial Structure Adjustment*, or the Guidance Catalogue, which is the basis and criteria for implementing the Interim Provisions, issued by the National Development and Reform Commission on December 2, 2005, the Chinese government encourages (i) the design and fabrication of integrated circuits with a linewidth of less than 1.2 micron, (ii) the fabrication of the equipment of large scale integrated circuit and (iii) the fabrication of mixed integrated circuits. Under the Interim Provisions, imported equipment that is used for a qualifying domestic investment project and that falls within such project s approved total investment amount is exempt from customs duties and import-linked value-added tax, except for such equipment listed in the *Catalogue of Import Commodities for Domestic Investment Projects Not Subject to Tax Exemptions,* as stipulated by the State Council and amended in 2000.

Encouragement of Foreign Investment in ICPEs

Pursuant to the Integrated Circuit Policies and the *Guideline Catalogue of Foreign Investment Industries* promulgated jointly by the former State Development and Planning Commission, the former State Economic and Trade Commission and the former Ministry of Foreign Trade and Economic Relations on March 11, 2002, as amended by the State Development and Reform Commission and the Ministry of Commerce on November 30, 2004, the following foreign investment categories are encouraged:

- design and fabrication of integrated circuits with a linewidth of less than 0.35 micron;
- development and fabrication of semiconductors and special materials for semiconductors; and
- fabrication of mixed integrated circuits.

Foreign investment in such encouraged projects may enjoy preferential treatment as stipulated by the laws and regulations.

Preferential Taxation Policies

Preferential Value-added Tax Policy

Under Article 1 of the Further Development Taxation Notice of the Ministry of Finance and Administration of Taxation on the Tax Policies For Further Encouraging the Development of Software and Integrated Circuit Industries (October 10, 2002 No. 70 [2002] Cai-Shui), from January 1, 2002 to the end of 2010, the sale of self-made integrated circuits (including monocrystalline silicon chips) is subject to a value-added tax levy of 17%. After the value-added tax is levied, the taxpayer was to be entitled to a refund for the portion exceeding 3% of the actual value-added tax

burden. The tax refund was required to be used by the enterprise for the research and development of integrated circuits and to increase production.

Under the Termination Notice of the Ministry of Finance and the State Administration of Taxation on Stopping the Tax Refund Policy of Value-added Tax on Integrated Circuit (No. 174 [2004] of the Ministry of Finance), as of April 1, 2005, implementation of Article 1 of the Further Development Taxation Notice was terminated.

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Under the Export Notice of the Ministry of Finance and the State Administration of Taxation on Increasing the Export Tax Refund Rate of a Part of IT Products (No. 200 [2004] Cai-shui), as of November 1, 2004, the tax refund rate for exports of integrated circuits is to increase from 13% to 17%.

Preferential Enterprise Income Tax Policies

Under the Integrated Circuit Policies and the Integrated Circuit Notice of the State Council of the People s Republic of China on Encouraging the Development of Software and Integrated Circuit Industries (No. 18 [2000] Guo-fa), ICPEs whose total investment exceeds Rmb 8,000 million (approximately US$967 million) or whose integrated circuits have a linewidth of less than 0.25 micron are entitled to preferential tax treatment similar to that granted for foreign investment in the energy and communications industries. The Income Tax Law of the People s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, or the Income Tax Law, and the Implementation Rules for the Income Tax Law provide preferential treatment of, exemption from or reduction of foreign enterprise income tax, or FEIT, for enterprises with foreign investment engaged in the energy and communications industries. After approval by the relevant taxation authorities, each of SMIC Shanghai, SMIC Beijing and SMIC Tianjin will become entitled to a 15% FEIT and a full exemption from FEIT for five years starting with the first year of positive accumulated earnings and a 50% reduction for the following five years.

From January 1, 2002 to the end of 2010, investors in ICPEs and integrated circuit packaging enterprises that reinvest their after-income-tax profits from ICPEs for the purpose of increasing the registered capital in the ICPEs, or to establish other ICPEs and integrated circuit packaging enterprises for a period of operation of not less than five years, are entitled to a refund of 40% of the total amount of enterprise income tax paid on the reinvested portion. If the investment is withdrawn before the period of operation reaches five years, the amount of enterprise income tax refunded shall be repaid. From January 1, 2002 to the end of 2010, domestic or foreign investors that reinvest their after income-tax profits from sources within China in order to establish ICPEs or integrated circuit package enterprises in China s western regions for a period of operation of not less than five years are entitled to a refund of 80% of total amount of enterprise income tax paid on the reinvested portion. If the investment is withdrawn before the period of operation reaches five years, the amount of enterprise income tax refunded shall be repaid.

Preferential Time Limit for Depreciation of Equipment Used in Production

Under Article 2 (2) of the Integrated Circuit Notice of the Ministry of Finance and Administration of Taxation on the Tax Policies for Further Encouraging the Development of Software and Integrated Circuit Industries (No. 25 [2000] Cai-Shui), upon approval by the State Administration of Taxation of foreign investment enterprises whose total investment exceeds US$30 million, and upon approval by the relevant local or provincial taxation authorities of foreign investment enterprises whose total investment is less than US$30 million, the time limit for depreciation of equipment used by an ICPE for production purposes may be shortened to not less than three years.

Under the Approval Notice, Article 2(2) of the Integrated Circuit Notice concerning the approvals by the competent tax authorities is terminated and an ICPE is entitled to decide by itself the time limit for depreciation of equipment used for production purpose when preparing for income tax declaration.

Exemption of Customs Duties and Import-related Value-added Tax

Under the Integrated Circuit Policies and the Integrated Circuit Notice of the State Council of the People s Republic of China on Encouraging the Development of Software and Integrated Circuit Industries (No. 18 [2000] Guo-fa), ICPEs whose total investment exceeds Rmb 8,000 million or whose integrated circuits have a linewidth of less than 0.25 micron are exempt from customs duties and import-related value-added tax when importing the raw materials and consumables for the production purpose of ICPEs..

The Raw Materials Taxation Notice further sets forth a detailed list of the raw materials and consumables used for production that are subject to the preferential tax treatment set forth above.

Under the Integrated Circuit Notice, integrated circuit technology, production equipment, and equipment and instruments specialized for use in fabricating integrated circuits that are imported by a duly accredited ICPE are, with the exception of commodities listed in the *Catalogue of Imported Commodities for Foreign Investment Projects Not Subject to Tax Exemptions* as stipulated by the State Council and the *Catalogue of Imported Commodities for Domestic Investment Projects Not Subject to Tax Exemptions* as stipulated by the State Council and amended in 2000, exempt from customs duties and import-related value-added tax.

Under the Construction Materials Taxation Notice of the Ministry of Finance and Administration of Taxation on the Tax Policies for the Clean Room Construction Materials of the Integrated Circuit Industry (No. 152 [2002] Cai-shui), commencing January 1, 2001, the importation of construction materials, auxiliary equipment and spare parts for the production of integrated circuits, specifically for clean rooms (as listed in the

annex to the Construction Materials Taxation Notice), by ICPEs whose total investment exceeds Rmb 8,000 million or whose integrated circuits have a linewidth of less than 0.25 micron is exempt from customs duties and import-related value-added tax.

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Preferential Policies Encouraging Research and Development

Under the Fund Measures, enterprises duly incorporated as independent legal entities in the PRC (except for Hong Kong, Macao and Taiwan) engaging in the design, fabrication, package or testing of integrated circuits may apply for the special fund designed to support exclusively the research and development of the integrated circuit industry. Such fund is appropriated from central budget and the application for it is subject to the review and approval by the Examination Committee consisting of the members from the Ministry of Finance, the National Development and Reform Commission and the Ministry of Information Industry. The special fund for research and development shall be in a form of gratuitous aid and the amount of such aid to a single research and development activity shall not exceed 50 % of the expenditures thereof.

Legal Framework Concerning the Protection of Intellectual Property Relating to Integrated Circuits

China has formulated various laws and regulations on intellectual property protection in respect of integrated circuits including:

- the *Patent Law of the People s Republic of China*, adopted at the fourth meeting of the Standing Committee of the Sixth National People s Congress on March 12, 1984, effective April 1, 1985, as amended at the seventeenth meeting of the Standing Committee of the Ninth National People s Congress on August 25, 2000;

- the *Paris Convention for the Protection of Industrial Property* of the World Intellectual Property Organization, in which China became a member state as of March 19, 1985;

- the *General Principles of the Civil Law of the People s Republic of China* adopted at the fourth session of the Sixth National People s Congress on April 12, 1986, effective January 1, 1987. In this legislation, intellectual property rights were defined in China s basic civil law for the first time as the civil rights of citizens and legal persons;

- the *Copyright Law of the People s Republic of China*, adopted by the 15th meeting of the Seventh National People s Congress Standing Committee on September 7, 1990, effective June 1, 1991, as amended at the twenty-fourth meeting of the Standing Committee of the Ninth National People s Congress on October 27, 2001;

- the *Regulations for the Protection of the Layout Design of Integrated Circuits*, or the Layout Design Regulations, adopted March 28, 2001 at the thirty-sixth session of the executive meeting of the State Council, effective October 1, 2001; and

- the World Intellectual Property Organization s *Washington Treaty on Intellectual Property in Respect of Integrated Circuits*, for which China was among the first signatory states in 1990.

Protection of the Layout Design of Integrated Circuits

Under the Layout Design Regulations, layout design of an integrated circuit refers to a three dimensional configuration in an integrated circuit that has two or more components, with at least one of these being an active component, and part or all of the interconnected circuitry or the three-dimensional configuration prepared for the production of integrated circuits.

Chinese natural persons, legal persons or other organizations that create layout designs are entitled to the proprietary rights in the layout designs in accordance with the Layout Design Regulations. Foreign persons or enterprises that create layout designs and have them first put into commercial use in China are entitled to the proprietary rights in the layout designs in accordance with the Layout Design Regulations. Foreign persons or enterprises that create layout designs and that are from a country that has signed agreements with China regarding the protection of layout designs, or is a party to an international treaty concerning the protection of layout designs to which China is also a party, are entitled to the proprietary rights of the layout designs in accordance with the Layout Design Regulations.

Proprietary Rights in Layout Design of Integrated Circuits

Holders of proprietary rights in a layout design are entitled to the following proprietary rights:

to duplicate the whole protected layout design or any part of the design that is original; and

to make commercial use of the protected layout design, the integrated circuit containing the layout design, or commodities containing the integrated circuit.

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Proprietary rights in layout designs become valid after being registered with the administrative department of the State Council responsible for intellectual property. Unregistered layout designs are not protected by the Layout Design Regulations.

The protection period of the proprietary rights in a layout design is ten years, commencing from the date of the application for registration of the layout design or the date that it is put into commercial use anywhere in the world, whichever is earlier. However, regardless of whether or not a layout design is registered, or whether or not it is put into commercial use, it is not protected after 15 years from the time of its creation.

Registration of a Layout Design

The administrative departments of the State Council responsible for intellectual property are responsible for the registration of layout designs and accepting applications for the registration of layout designs. If an application for a layout design registration is not made with the administrative department of the State Council responsible for intellectual property within two years after it has been put into commercial use anywhere in the world, the administrative department of the State Council responsible for intellectual property will not register the application. A holder of proprietary rights in a layout design may transfer the proprietary rights or give permission for other parties to use the layout design.

Compulsory Licenses for Exploitation of Patents in Respect of Semiconductor Technology

Under the Patent Law and the Implementing Regulations of the Patent Law, after three years from the date of granting the patent rights, any person or enterprise that has made good faith reasonable proposals to the holder of proprietary rights seeking a license to those rights, but has been unable to obtain such license after an extended period of time, may request the administrative department responsible for patents under the State Council to grant a compulsory license for the relevant patent. However, where a compulsory license involves semiconductor technology, the implementation of a compulsory license is restricted to public and non-commercial uses, or to uses that counteract anti-competitive actions, as determined by judicial or administrative procedures.

Income Tax on Fees for the Use of Proprietary Technology

Under the *Provisional Regulations Concerning the Reduction and Exemption of Income Tax on Fees for the Use of Proprietary Technology,* issued by the Ministry of Finance on December 13, 1982, preferential income tax treatment is granted with respect to fees for the use of proprietary technology concerning certain integrated circuit production technologies, provided that such proprietary technology is licensed by a foreign company, enterprise or other economic organization which has no establishment in the territory of the PRC. With respect to fees for the use of the proprietary technology (including fees for blueprints and documentation, fees for technical services and fees for personnel training relating to the right of use of the transferred proprietary technology), such as technology for fabricating integrated circuits, income tax may be levied at a reduced rate of 10%. Income tax may be exempted if the relevant technology is deemed to be advanced and the terms for use of the proprietary technology are preferential.

Environmental Regulation

Our Chinese subsidiaries are subject to a variety of Chinese environmental laws and regulations promulgated by the central and local governments concerning examination and acceptance of environmental protection measures in construction projects, the use, discharge and disposal of toxic and hazardous materials, the discharge and disposal of waste water, solid waste, and waste gases, control of industrial noise and fire prevention. These laws and regulations set out detailed procedures that must be implemented throughout a project s construction and operation phases.

A key document that must be submitted for the approval of a project s construction is an environmental impact assessment report that is reviewed by the relevant environmental protection authorities. Upon completion of construction, and prior to commencement of operations, an additional examination and acceptance by the relevant environmental authority of such projects is also required. Within one month after receiving approval of the environmental impact assessment report, a semiconductor manufacturer is required to apply to and register with the competent environmental authority the types and quantities of liquid, solid and gaseous wastes it plans to discharge, the manner of discharge or disposal, as well as the level of industrial noise and other related factors. If the above wastes and noise are found by the authorities to have been managed within regulatory levels, renewable discharge registrations for the above wastes and noise are then issued for a specified period of time. At present, the Shanghai mega-fab has received approval with respect to the relevant environmental impact assessment report and believes it can receive the discharge permit in the second half of 2006. The solar cell fab located on the Shanghai site has received approval with respect to the relevant environmental impact assessment report and believes that it can receive the discharge permit in the first half of 2007. SMIC Tianjin and SMIC Beijing have received approval with respect to their relevant environmental impact assessment reports and discharge registrations. Semiconductor Manufacturing International (Chengdu) Corporation, which is our testing and assembly joint venture, has received approval with respect to the relevant environmental impact assessment report and is in the process of applying for a discharge registration.

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From time to time during the operation of our Chinese subsidiaries, and also prior to renewal of the necessary discharge registrations, the relevant environmental protection authority will monitor and audit the level of environmental protection compliance of these subsidiaries. Discharge of liquid, solid or gaseous waste over permitted levels may result in imposition of fines, imposition of a time period within which rectification must occur or even suspension of operations.

Enforceability Of Civil Liabilities

We are a Cayman Islands holding company. We are incorporated in the Cayman Islands because of the following benefits associated with being a Cayman Islands corporation:

- political and economic stability;
- an effective judicial system;
- a favorable tax system;
- the absence of exchange control or currency restrictions; and
- the availability of professional and support services.

However, the Cayman Islands have a less developed body of securities laws as compared to the United States and provides significantly less protection for investors. In addition, Cayman Islands companies may not have standing to sue before the federal courts of the United States. Substantially all of our assets are located outside the United States. In addition, most of our directors and officers are nationals and/or residents of countries other than the United States, and all or a substantial portion of our or such persons assets are located outside the United States. As a result, it may be difficult for a shareholder to effect service of process within the United States upon us or such persons or to enforce against them or against us, judgments obtained in United States courts, including judgments predicated upon the civil liability provisions of the securities laws of the United States or any state thereof.

Maples and Calder, our counsel as to Cayman Islands law, Slaughter and May, our counsel as to Hong Kong law, and Fangda Partners, our counsel as to Chinese law, have advised us that there is uncertainty as to whether the courts of the Cayman Islands, Hong Kong and China, respectively, would:

- recognize or enforce judgments of United States courts obtained against us or our directors or officers predicated upon the civil liability provisions of the securities laws of the United States or any state thereof, or
- be competent to hear original actions brought in each respective jurisdiction, against us or our directors or officers predicated upon the securities laws of the United States or any state thereof.

Maples and Calder has further advised us that a final and conclusive judgment in the federal or state courts of the United States under which a sum of money is payable, other than a sum payable in respect of taxes, fines, penalties or similar charges, may be subject to enforcement proceedings as a debt in the Courts of the Cayman Islands under the common law doctrine of obligation.

Organizational Structure

We operate primarily through three wholly owned subsidiaries in China. The chart below sets forth our significant operating subsidiaries or affiliates, including their jurisdictions of incorporation and principal activities:

Name of company	Place and date of incorporation/establishment	Attributable equity interest held	Principal Activity
Garrison Consultants Limited	Western Samoa April 3, 2000	100%	Provision of consultancy services
Betterway Enterprises Limited	Western Samoa April 5, 2000	100%	Provision of marketing related services
Semiconductor Manufacturing International (Shanghai) Corporation*	The People s Republic of China (the PRC) December 21, 2000	100%	Manufacturing and trading of semiconductor products

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Semiconductor Manufacturing International (Beijing) Corporation*	The PRC July 25, 2002	100%	Manufacturing and trading of semiconductor products
Semiconductor Manufacturing International (Tianjin) Corporation*	The PRC November 3, 2003	100%	Manufacturing and trading of semiconductor products
SMIC Japan Corporation	Japan October 8, 2002	100%	Provision of marketing related activities
SMIC Europe S.R.L.	Italy July 3, 2003	100%	Provision of marketing related activities
SMIC, Americas	United States of America June 22, 2001	100%	Provision of marketing related activities
Semiconductor Manufacturing International (AT) Corporation	Cayman Islands July 26, 2004	56.6%	Investment holding
Semiconductor Manufacturing International (Chengdu) Corporation*	The PRC August 16, 2004	56.6%	Manufacturing and trading of semiconductor products
SMIC Commercial (Shanghai) Limited Company (formerly SMIC Consulting Corporation) *	The PRC September 30, 2003	100%	Operation of a convenience store
Semiconductor Manufacturing International (Solar Cell) Corporation	Cayman Islands June 30, 2005	100%	Investment holding
SMIC Energy Technology (Shanghai) Science Corporation*	The PRC September 9, 2005*	100%	Manufacturing and trading of solar cell related semiconductor products

* Companies registered as wholly foreign-owned enterprises in the PRC.

Property, plant and equipment

Equipment

The quality and level of technology of the equipment used in the semiconductor fabrication process are important because they dictate the limits of the process technology that we use. Advances in process technology cannot be achieved without corresponding advances in equipment technology. The principal pieces of equipment used by us to fabricate semiconductors are scanners, cleaners and track equipment, inspection equipment, etchers, furnaces, wet stations, strippers, implanters, sputterers, CVD equipment, testers and probers. We source substantially all of our equipment from vendors located in the United States, Europe and Japan. Our main equipment vendors include Applied Materials Asia-Pacific, Ltd., ASML Holding NV, KLA Tencor Corporation, Lam Research Corporation, Novellus Systems, Inc. and Tokyo Electron Limited.

In implementing our capacity expansion and technology advancement plans, we expect to make significant purchases of equipment required for semiconductor fabrication. Some of the equipment is available from a limited number of vendors and/or is manufactured in relatively limited quantities, and in some cases has only recently become commercially available. Our ability to obtain certain kinds of equipment from outside of China may be subject to restrictions. See Risk Factors Risks Related to Conducting Operations in China Limits placed on exports into China could substantially harm our business and operating results. To date, however, we have not experienced any major difficulties or delays in sourcing, purchasing and installing the equipment we need to fabricate wafers for our customers.

We maintain our equipment through a combination of in-house maintenance and outside contracting to our equipment vendors. We decide whether to maintain ourselves, or subcontract the maintenance of, a particular piece of equipment based on a variety of factors, including cost, complexity and regularity of the required periodic maintenance and the availability of maintenance personnel in China. Most of our equipment vendors offer maintenance services through technicians based in China.

Property

Our corporate headquarters and our mega-fab in Shanghai occupy 367,895 square meters of land, for which we hold valid land use rights certificates. These fabs currently occupy approximately 45% of this total land area. We also hold valid land use rights for the 240,140 square meters of land that comprise our Beijing site, approximately 75% of which will be occupied by the Beijing mega-fab. In 2005, we received land use rights certificates for 215,733 square meters of land in Tianjin, which is occupied by the Tianjin fab. We own all of the buildings and equipment for our fabs, except for certain customer-owned tooling provided to our Shanghai operations for test production on a consignment basis from our customers.

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The following table sets forth the location, size and primary use of our real properties and whether such real properties are owned or leased.

Location	Size (Land/Building) (in square meters)	Primary Use	Owned[1] or Leased (Land/Building)
Zhangjiang High-Tech Park, Pudong New Area, Shanghai	367,895/164,795	Wafer fabrication	owned/owned
Beijing Economic and Technological Development Area	240,140/143,017	Wafer fabrication	owned/owned
Xiqing Economic Development Area, Tianjin	215,733/61,990	Wafer fabrication	owned/owned
Japan	na/55	Marketing activities	na/leased
USA	na/743	Marketing activities	na/leased
Italy	na/280	Marketing activities	na/leased
Hong Kong[2]	na/100	Representative Office	na/leased

(1) With respect to land located in China, ownership refers to holding a valid land use rights certificate. All land within municipal zones in China is owned by the Chinese government. Limited liability companies, joint stock companies, foreign-invested enterprises, privately held companies and individual natural persons must pay fees to be granted rights to use land within municipal zones. Legal use of land is evidenced and sanctioned by land use certificates issued by the local municipal administration of land resources. Land use rights granted for industrial purposes are limited to a term of no more than 50 years.

(2) In February 2006, we purchased approximately 300 square meters of property in Hong Kong through our indirect wholly-owned subsidiary, Magnificent Tower Limited, a company incorporated under the laws of British Virgin Islands.

Our right to continued use of the land is subject to our continued compliance with the land use agreement that each of our Chinese subsidiaries has executed. The Chinese government has reserved the right to revoke our land use rights for special eminent domain purposes, in which case the government will compensate us. In addition, pursuant to an amendment to its domestic bank loan agreements, SMIC Shanghai has pledged a portion of its land use right to the lenders. See Item 5 Operating and Financial Review and Prospects Liquidity and Capital Resources.

For a description concerning our capacity, capacity utilization rate and capacity expansion plans, please see Item 5-Operating and Financial Review and Prospects-Factors that Impact our Results of Operations.

Risk Management and Insurance

Our safety management philosophy is based on incident prevention and frequent safety audits. Incident prevention is achieved through:

- mandatory staff and vendor safety training;
- compliance of equipment and facilities to safety criteria, including the Semiconductor Equipment and Materials International and Chinese National Fire Protection Association standards; and
- standard management procedures established by our environmental, health and safety committee.

Regularly scheduled safety audits are performed in accordance with established world standards, and we have been qualified under OHSAS 18001 internal auditing standards as of September 2003.

We have established a risk management committee and an emergency response center to respond to all emergencies. The facility monitoring and control system and security monitoring room located within our emergency response center are where all emergency responses begin. These rooms are equipped with 24-hour safety and security monitoring systems such as closed circuit television, gas monitoring systems, chemical dispensing systems, very early smoke detection apparatus, public announcement systems, and fire alarm systems.

Each department conducts emergency drills on a quarterly basis in accordance with our emergency response plan to address all possible emergency situations that could arise. These emergency scenarios include fires, gas leakages, chemical spills, and power losses.

We maintain insurance with respect to our facilities, equipment, and inventories. The insurance for the fabs and their equipment covers, subject to some limitations, various risks, including industrial accidents and natural disasters, generally up to their respective replacement values and lost profits due to business interruption. We have not made any significant claims under these insurance policies. Equipment and inventories in transit are also insured. We believe that our overall insurance coverage is adequate.

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Environmental Matters

The semiconductor production process generates gaseous chemical wastes, liquid waste, waste water, and other industrial wastes in various stages of the fabrication process. We have installed various types of pollution control equipment for the treatment of gaseous chemical waste and liquid waste and equipment for the recycling of treated water in our fabs, and of recycling equipment. Our operations are subject to regulation and periodic monitoring by China s State Environmental Protection Bureau, as well as local environmental protection authorities, including those under the Pudong Municipal Government, the Tianjin Municipal Government, and the Beijing Municipal Government, which may in some cases establish stricter standards than those imposed by the State Environmental Protection Bureau. The Chinese national and local environmental laws and regulations impose fees for the discharge of waste substances above prescribed levels, require the payment of fines for serious violations, and provide that the Chinese national and local governments may at their own discretion close or suspend any facility that fails to comply with orders requiring it to cease or remedy operations causing environmental damage. No such penalties have been imposed on us or any of our subsidiaries, and we believe that we have been in material compliance with applicable environmental regulations and standards.

We believe that we have adopted pollution control measures for the effective maintenance of environmental protection standards consistent with the requirements applicable to the semiconductor industry in China. Waste generated from our operations, including acid waste, alkaline waste, flammable waste, toxic waste, oxide waste, and self-igniting waste, are collected and sorted for proper disposal. Furthermore, we have in many cases implemented waste reduction steps beyond the scope of current regulatory requirements.

We received ISO 14001 certification for our Fab 1 in the Shanghai mega-fab in August 2002 from the British Standards Institute and continue to implement improvement programs in connection with this certification. Our Fab 2 and Fab 3B, both in the Shanghai mega-fab, achieved ISO 14001 certification in February 2003. The ISO 14001 quality standard is a voluntary standard and part of a comprehensive series of quality standards for environmental management published by the International Standards Organization. The ISO 14001 quality standards cover environmental management principles, systems and supporting techniques. In 2006, our Fab 1 and Fab 2 were certified as Sony s Green Partners. Sony s Green Partner program requires companies to comply with policies that prevent and minimize hazardous environmental impact in product development and manufacturing.

Item 4A. Unresolved Staff Comments

Not applicable.

Item 5. Operating and Financial Review and Prospects

Overview

We were founded in April 2000. In 2000 and 2001, our company was in its development stage and did not have any sales. During this period, we established our management structure, acquired land use rights, constructed, equipped and commenced the ramp-up of production at our 8-inch wafer facilities in Shanghai which are referred to as the Shanghai mega-fab, and began our research and development activities. The first fab in the Shanghai mega-fab and the portion of our second fab which provides aluminum interconnects, commenced commercial production in January 2002. The portion of our second fab which provides copper interconnects and a third fab commenced commercial production in January 2003. In January 2004, we acquired an 8-inch fab in Tianjin, China, from MCEL, a wholly owned subsidiary of Motorola. The first fab in the Beijing mega-fab commenced commercial production in March of 2005. As of December 31, 2005, we had reached total wafer fabrication capacity of 152,219 8-inch wafer equivalents per month. We believe that this speed of capacity ramp-up represents one of the fastest in the semiconductor industry. Our wafers shipped and sales increased from 82,486 wafers and US$50.3 million for 2002 to 476,451 wafers and US$365.8 million for 2003 to 943,463 wafers and US$974.6 million for 2004 to 1,347,302 wafers and US$1,171.3 million for 2005.

We manage our business and measure our results of operations based on a single operating segment. We plan to have aggregate monthly wafer fabrication capacity of 185,000 8-inch wafer equivalents by the end of 2006. As we increase our capacity and corresponding wafer production, we benefit from economies of scale. When our capacity utilization is high, these economies of scale enable us to reduce our per wafer production cost and improve our margins. On the other hand, when our capacity utilization rate is low, our unused capacity results in higher per wafer production cost and decreased margins.

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Factors that Impact Our Results of Operations

Cyclicality of the Semiconductor Industry

The semiconductor industry is highly cyclical due mainly to the cyclicality of demand in the markets of the products that use semiconductors. As these markets fluctuate, the semiconductor market also fluctuates. This fluctuation in the semiconductor market is exacerbated by the tendency of semiconductor companies, including foundries, to make capital investments in plant and equipment during periods of high demand since it may require several years to plan, construct and commence operations at a fab. Absent sustained growth in demand, this increase in capacity often leads to overcapacity in the semiconductor market, which in the past has led to a significant underutilization of capacity and a sharp drop in semiconductor prices. The semiconductor industry is generally slow to react to declines in demand due to its capital-intensive nature and the need to make commitments for equipment purchases well in advance of the planned expansion.

The semiconductor industry has experienced a period of declining demand since 2001, mainly due to a downturn in the global economy and in the communications sector in particular. At the same time, the semiconductor industry has faced significant overcapacity due to capacity increases that were initiated prior to the downturn, as well as technological advancements in process technology and wafer sizes that have allowed for more chips to be fabricated per wafer. These conditions led to inventory build-up and a reduction in overall average selling prices for foundry services during this period. We believe the semiconductor industry is currently experiencing an increase in demand due to improving global economic conditions and a resulting strengthening in consumer confidence.

Substantial Capital Expenditures

The semiconductor foundry industry is characterized by substantial capital expenditures. This is particularly true for our company as we have recently constructed and equipped fabs and are continuing to construct and equip new fabs. In connection with the construction and ramp-up of our capacity since our inception, we incurred capital expenditures of US$897 million, US$492 million, US$2,000 million and US$903 million in 2002, 2003, 2004, and 2005 respectively. We depreciate our manufacturing machinery and equipment on a straight-line basis over an estimated useful life of five years. We recorded depreciation and amortization of US$84.5 million, US$233.9 million, US$457.0 million and US$745.9 million in 2002, 2003, 2004 and 2005, respectively.

The semiconductor industry is also characterized by rapid changes in technology, frequently resulting in obsolescence of process technologies and products. As a result, our research and development efforts are essential to our overall success. After giving effect to the reclassification, as described below, we spent approximately US$34.9 million in 2003, US$74.1 million in 2004 and US$78.9 million in 2005 for research and development, which represented 9.5%, 7.6% and 6.7%, respectively, of our sales for 2003, 2004 and 2005. Our research and development costs include non-recurring engineering costs associated with the ramp-up of a new wafer facility. These research and development costs are subsequently classified in cost of sales upon commencement of commercial production at that particular wafer facility.

We currently expect that our capital expenditures in 2006 will reach approximately US$1,100 million, which we plan to fund through our operating cash flows and bank loans in order to expand our operations. If necessary, we will also explore other forms of external financing. In addition, our actual expenditures may exceed our planned expenditures for a variety of reasons, including changes in our business plan, our process technology, market conditions, equipment prices, customer requirements or interest rates. We will monitor the global economy, the semiconductor industry, the demands of our customers, and our cash flow from operations to adjust our capital expenditure plans.

Capacity Expansion

We have expanded, and plan to continue to expand, our capacity through internal growth and acquisitions. An increase in capacity may have a significant effect on our results of operations, both by allowing us to produce and sell more wafers and achieve higher sales, and as a cost component in the form of acquisition costs and depreciation expenses. We plan to have aggregate wafer fabrication capacity of 185,000 8-inch wafer equivalents per month by the end of 2006.

We also will seek to participate in strategic partnerships to expand our capacity. For example, in July 2004, we entered into an agreement with Toppan Printing Co., Ltd., to establish Toppan SMIC Electronics (Shanghai) Co., Ltd. to manufacture color filters and micro lenses for CMOS image sensors. Toppan SMIC Electronics (Shanghai) Co., Ltd. commenced pilot production in December 2005.

Pricing

We price our foundry services on either a per wafer or a per die basis, taking into account the complexity of the technology, the prevailing market conditions, the order size, the cycle time, the strength and history of our relationship with the customer, and our capacity utilization.

Since a majority of our costs and expenses are fixed or semi-fixed, fluctuations in the average selling prices of semiconductor wafers have historically had a substantial impact on our margins. The average selling price of the wafers we shipped

decreased 14.8% from US$979 per wafer in 2004 to US$834 per wafer in 2005, mainly due to declines in DRAM prices and industry pricing softness. Prices of our different process technologies vary significantly and, in general, the prices of the specific process technologies we provide decrease over time as the technology employed gradually becomes more mature and commoditized. Therefore, it is necessary to continually introduce new higher margin and more technologically advanced services to help counteract this trend of decreasing price levels.

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Change in Process Mix and Technology Migration

Because the price of wafers processed with different technologies varies significantly, the mix of wafers that we produce is among the primary factors that affect our sales and profitability. The value of a wafer is determined principally by the complexity of the process technology used to fabricate the wafer. In addition, production of devices with higher levels of functionality and greater system-level integration requires more fabrication steps, and these devices generally sell for higher prices.

Prices for wafers of a given level of technology generally decline over the relevant process technology life cycle. As a result, we and our competitors are continuously in the process of developing and acquiring advanced process technologies and migrating our customers to use such technologies to maintain or improve our profit margins. This technology migration requires continuous investment in research and development and technology-related acquisitions, and we expect to continue to spend a substantial amount of capital on upgrading our technologies.

Our initial sales after commencing commercial operations in 2002 consisted mainly of DRAM fabricated and sold on a foundry basis, as well as commodity-type DRAM fabricated using technology licensed from Fujitsu Limited and sold by us to distributors. This commodity-type DRAM was fabricated during our start-up phase in order to test and ramp up our facilities and train our personnel. As our business has grown and our fabs have matured, we have produced proportionately less commodity-type DRAM and more logic products and memory products utilizing more advanced technologies, which generally command a higher margin. However, we intend to continue to produce commodity-type DRAM to maintain high utilization of our capacity in the future.

The following table sets forth a percentage breakdown of wafer sales by process technology for the years ended December 31, 2003, 2004 and 2005 and each of the quarters in the year ended December 31, 2005:

	For the year ended December 31,		For the three months ended				For the year ended
Process Technologies	**2003**	**2004**	**March 31, 2005**	**June 30, 2005**	**September 30, 2005**	**December 31, 2005**	**December 31, 2005**
				(based on sales in US$)			
0.13 micron	11.8%	11.7%	29.2%	44.5%	43.8%	42.9%	40.6%
0.15 micron	9.9%	14.2%	12.5%	2.5%	2.7%	5.2%	5.4%
0.18 micron	22.0%	42.6%	40.3%	40.7%	45.3%	42.3%	42.3%
0.25 micron	34.5%	7.1%	4.6%	3.9%	3.1%	3.3%	3.7%
0.35 micron	21.8%	24.4%	13.4%	8.4%	5.1%	6.3%	8.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

The following table sets forth a breakdown of our sales by service type for 2003, 2004 and 2005:

	For the year ended December 31					
	2003		2004		2005	
Service Type	**Sales**	**Percentage**	**Sales**	**Percentage**	**Sales**	**Percentage**
	(in US$ thousands, except percentages)					
Fabrication of DRAM wafers	$ 139,553	38.1%	$ 193,950	19.9%	$ 384,587	32.8%
Fabrication of logic wafers[(1)]	209,914	57.4%	730,160	74.9%	739,296	63.1%
Other[(2)]	16,357	4.5%	50,554	5.2%	47,436	4.1%
Total	$ 365,824	100.0%	$ 974,664	100.0%	$ 1,171,319	100.0%

(1) Includes copper interconnects and memory devices whose manufacturing process is similar to that for a logic device.
(2) Includes mask-making and probing, etc.

Capacity Utilization Rates

Operations at or near full capacity have a significant positive effect on our profitability because a substantial percentage of our cost of sales is of a fixed nature. In 2003, 2004 and 2005, approximately 48%, 54% and 69.0%, respectively, of our cost of sales consisted of depreciation expenses, which are fixed costs. If we increase our utilization rates, the number of wafers we fabricate will increase, and therefore our average fixed costs per wafer will decrease. Therefore, our capacity utilization rates have a significant effect on our margins. Our utilization rates have varied from period to period due to capacity ramp-ups and fluctuations in customer orders. Our annual capacity utilization rate was 94% in 2003, 98% in 2004 and 89% in 2005. Factors affecting utilization rates are the complexity and mix of the wafers produced, overall industry conditions, the level of customer orders, and mechanical failures and other operational disruptions, such as those relating to capacity expansions or relocation of equipment.

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In addition, we fabricate DRAM wafers for sale to distributors using technology licensed from our technology partners, as well as under foundry arrangements for our customers using licensed technology. Through the fabrication of DRAM wafers, we have been able to quickly ramp up our production facilities, test and stabilize the process technologies and train our personnel. We expect that as we continue to ramp up our fabrication of logic wafers over time, the portion of our capacity utilized for DRAM production will become smaller relative to logic wafer production. This practice also has the added benefit of raising our ability to fabricate higher margin system-on-chip devices that incorporate elements of both memory and logic functions on a single chip.

Our capacity is determined by us based on the capacity ratings for each piece of equipment, as specified by the manufacturers of such equipment, adjusted for, among other factors, actual output during uninterrupted trial runs, expected down time due to set up for production runs and maintenance, and expected product mix. Because these factors include subjective elements, our measurement of capacity utilization rates may not be comparable to those of our competitors.

Yield Rates

Yield per wafer is the ratio of the number of functional dies on that wafer to the maximum number of dies that can be produced on that wafer. A significant portion of our services, particularly our memory semiconductor wafer fabrication services, is priced on a per die basis, and our high yields have assisted us in achieving higher margins.

We continuously upgrade the process technologies that we use. At the beginning of each technology migration, the yield utilizing the new technology is generally lower, sometimes substantially lower, than the yield under the then-current technology. This is because it requires time to stabilize, optimize and test a new process technology. We do not ship wafers to a customer until we have achieved that customer s minimum yield requirements. Yield is generally improved through the expertise and cooperation of our research and development personnel, process engineers, and equipment suppliers.

Critical Accounting Policies

The methods, estimates and judgments we use in applying our accounting policies have a significant impact on the results we report in our financial statements. Some of our accounting policies require us to make difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Below we have summarized our accounting policies that we believe are both important to the portrayal of our financial results and involve the need to make estimates about the effect of matters that are inherently uncertain. We also have other policies that we consider to be key accounting policies. However, these policies do not meet the definition of critical accounting estimates because they do not generally require us to make estimates or judgments that are difficult or subjective.

Inventory

Inventories are stated at the lower of cost or market. Market represents the net realizable value for finished goods and work-in-progress, and replacement cost for raw materials. For products manufactured pursuant to customer purchase orders, we are not typically exposed to the risk that the selling price will be lower than the inventory carrying value. We also use available manufacturing capacity to produce commodity-type DRAM that we hold in inventory until sold. We are exposed to the risk that the ultimate selling price of such commodity-type DRAM may be less than the inventory carrying value. We estimate the net realizable value for such finished goods and work-in-progress based primarily upon the latest invoice prices and current market conditions. If the market value of a good drops below its carrying value, we record a write-off to cost of sales for the difference between the carrying cost and the market value. As of December 31, 2003, December 31, 2004 and December 31, 2005, we carried a lower of cost or market reserve of US$nil, US$10.5 million and US$13.8 million, respectively, to reflect a decline in the estimated market value of the inventory we held on that date. We carry out an inventory review on an item-by-item basis at each quarter-end.

Depreciation and Amortization

We operate in a capital-intensive business. The net book value of our plant and equipment, including land use rights, at December 31, 2005 was US$3,320.4 million. Depreciation of manufacturing buildings and related improvements is provided on a straight-line basis over the estimated useful life of 25 years and commences from the date the facility is ready for its intended use. Depreciation of our manufacturing machinery and equipment, as well as our facility, machinery and equipment, is provided on a straight-line basis over the estimated useful life of 5 to 10 years, commencing from the date that the equipment is placed into productive use. Amortization of land use rights is over the term of the land use right agreement, which ranges from 50 to 70 years. The estimated useful life and dates that the equipment is placed into productive use reflects our estimate of the periods that we intend to derive future economic benefits from the use of our plant and equipment and land use rights.

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Long-lived Assets

We assess the impairment of long-lived assets when events or changes in circumstances indicate that the carrying value of the assets or the asset grouping may not be recoverable. Factors we consider in deciding when to perform an impairment review include significant under-performance of a manufacturing facility relative to expectations, significant underutilization of specific equipment relative to expectations, significant negative industry or economic trends, and significant changes or planned changes in our use of the assets. Recoverability of assets to be held and used is measured by comparing the carrying amount of the asset grouping to its future undiscounted cash flows. If such assets are considered to be impaired, an impairment charge is recognized for the amount that the carrying value of the asset exceeds its fair value. Assets held for sale are reported at the lower of their carrying amount or fair value less related selling costs.

In order to remain technologically competitive in our industry, we have entered into technology transfer and technology license arrangements with third parties in an attempt to advance our process technologies. The payments made for such technology licenses are recorded as an intangible asset and amortized on a straight-line basis over the estimated useful life of the asset. We routinely review the remaining estimated useful lives of these intangible assets. We also evaluate these intangible assets for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable.

We have continued to construct, acquire, and expand our manufacturing facilities since our inception and, to date, have not experienced any factors that would indicate potential impairment of our long-lived assets. We will continue to review impairment factors as described above and, as a result, impairment charges may be necessary in the future as circumstances change.

Revenue Recognition

We manufacture semiconductor wafers for our customers based on the customers designs and specifications pursuant to manufacturing agreements and purchase orders. We also sell certain semiconductor standard products to customers. Customers do not have any rights of return except pursuant to warranty provisions, which returns have been minimal. We typically perform tests of our products prior to shipment to identify yield of acceptable products per wafer. Occasionally, product tests performed after shipment identify yields below the level agreed with the customer. In those circumstances, the customer arrangement may provide for a reduction to the price paid or for its costs to ship replacement products. We estimate the amount of sales returns and the cost of replacement products based on the historical trend of returns and warranty replacements relative to sales and any current information regarding specific customer yield issues that may exceed historical trends. We recognize revenue upon shipment and title transfer. We also provide certain services such as mask making and probing and revenue is recognized when our services are completed.

Stock-based Compensation Expense

Our stock-based employee compensation plans are described in more detail under Share Ownership. We grant stock options to our employees and we record a compensation charge for the excess of the fair value of the stock at the measurement date over the amount an employee must pay to acquire the stock. We amortize stock-based compensation using the straight-line method over the vesting periods of the related options, which are generally four years.

We have recorded deferred stock-based compensation representing the difference between the fair value of our ordinary shares for accounting purposes and the option exercise price. Prior to the completion of our global offering, we determined the fair value of our ordinary shares based upon several factors, including a valuation report from an independent appraiser and the price of our then most recent preference share placement. Following the completion of our global offering, we have determined the fair value of our ordinary shares based on the closing price of our ADSs on the NYSE. We recorded deferred stock-based compensation of US$31.2 million, US$37.6 million and US$nil for stock options granted to employees during the years ended December 31, 2003, 2004 and 2005, respectively, and we amortized US$11.4 million, US$27.0 million and US$25.7 million for the years ended December 31, 2003, 2004 and 2005, respectively. Had different assumptions or criteria been used to determine the fair value of our ordinary shares, materially different amounts of stock-based compensation could have been reported.

Pro forma information regarding net income (loss) and net income (loss) per share is required in order to show our net income (loss) as if we had accounted for employee stock options under the fair value method. We use the Black-Scholes option pricing model to compute the fair value. The fair value of options and shares issued pursuant to our option plans at the grant date was estimated using this Black-Scholes option pricing model. This model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the expected stock price volatility. We use projected volatility rates, which are based upon historical volatility rates experienced by comparable public companies. Because our employee stock options issued under our 2001 Stock Plan, 2001 Regulation S Stock Plan, 2001 Preference Shares Stock Plan and 2001 Regulation S Preference Shares Stock Plan had characteristics significantly different from those of publicly traded options, and because changes

in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of our stock options.

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The effects of applying pro forma disclosures of net income (loss) and net income (loss) per share are not likely to be representative of the pro forma effects on net income and earnings per share in the future years for the following reasons:

- the number of future shares to be issued under these plans is not known; and
- the assumptions used to determine the fair value can vary significantly.

Inflation

Although there can be no assurance as to the impact in future periods, we believe that, to date, inflation in China has not had a material impact on our results of operations. Inflation in China was approximately 1.2%, 3.9% and 1.8% in 2003, 2004 and 2005, respectively.

Income Tax

As an exempted company incorporated in the Cayman Islands, we are exempt from Cayman Islands taxation. Our Chinese subsidiaries are subject to taxation pursuant to the Income Tax Law of the PRC Concerning Foreign Investment and Foreign Enterprises and various local income tax laws. Under relevant regulations and after approval by the local Tax Bureau, our Shanghai, Beijing and Tianjin subsidiaries will become entitled to a full exemption from foreign enterprise income tax, or FEIT, for five years starting with the first year of positive accumulated earnings, and a 50% reduction for the following five years. Our Shanghai subsidiary had positive accumulated earnings during the year ended December 31, 2004. Our other subsidiaries are subject to their respective jurisdictions income tax laws, including Japan and the United States. Our income tax obligations to date have been minimal.

We account for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. SFAS No. 109 requires an asset and liability approach for financial accounting and reporting for income tax purposes. Under the asset and liability method, deferred income taxes are recognized for temporary differences, net operating loss carry-forwards and credits by applying enacted statutory tax rates applicable to future years. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Foreign Currency Fluctuations

Our sales are generally denominated in U.S. dollars and our operating expenses and capital expenditures are generally denominated in U.S. dollars, Japanese Yen, Euros and Renminbi. Accordingly, we are affected by fluctuations in exchange rates between the U.S. dollar and each of the Japanese Yen, the Euro and the Renminbi. See Risk Factors Risks Related to Conducting Operations in China Devaluation or appreciation in the value of the Renminbi or restrictions on convertibility of the Renminbi could adversely affect our operating results and Risk Factors Risks Related to Our Financial Condition and Business Exchange rate fluctuations could increase our costs, which could adversely affect our operating results and the value of our ADSs for a discussion of the effects on our company of fluctuating exchange rates and Item 11-Quantative and Qualitative Disclosures About Market Risk-Foreign Exchange Rate Fluctuation Risk for a discussion of our efforts to minimize such risks.

Recent Accounting Pronouncements

Our adoption of the following recently issued accounting pronouncements did not have a material impact on our financial position, cash flows or results of operations. We have reflected all disclosure requirements of these pronouncements in our financial statements.

- FASB Interpretation (FIN), No. 46(R), Consolidation of Variable Interest Entities.
- Staff Accounting Bulletin, No. 104, Revenue Recognition (SAB 104), which codifies, revises, and rescinds certain sections of SAB 101, Revenue Recognition in Financial Statements.

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EITF Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments.

As of December 31, 2005, we had not yet adopted the following recently issued accounting pronouncements because they are not yet applicable in part or in total:

SFAS No. 151, Inventory Costs an amendment of ARB No. 43 Chapter 43 , which is effective for inventory costs incurred during the fiscal years beginning after June 15, 2005.

SFAS No. 123R (revised 2004), Share Based Payment, applicable commencing with our fiscal quarter beginning January 1, 2006.

FASB 154, Accounting Changes and Error Corrections, which is effective for accounting changes and corrections of errors made in fiscal years beginning after December 31, 2005.

During the first quarter of 2006, we recognized a one-time credit adjustment of $5.2 million as a cumulative effect of the adoption of SFAS 123R.

Incentives from the Chinese government

The chart below sets forth a brief summary of the material incentives received by our Chinese subsidiaries from the Chinese government. Our Shanghai, Beijing, and Tianjin subsidiaries are qualified as integrated circuit production enterprises under the Chinese government s *Several Policies to Encourage the Development of Software and Integrated Circuit Industry*. Under these policies, any company that engages in the semiconductor industry in China and has a total investment size in excess of 8,000 million Renminbi (approximately US$964 million) and fabricates integrated circuits that have a linewidth of less than 0.25 micron are entitled to the last three benefits listed below. We believe that our Shanghai, Beijing, and Tianjin subsidiaries are among only a few companies in China that have qualified for these benefits. For a more detailed discussion of these incentives, see Item 4 Information on the Company Regulation.

Incentive	**SMIC Shanghai**	**SMIC Beijing**	**SMIC Tianjin**
Preferential Value-added Tax Policies	- 17% VAT rate	- 17% VAT rate	- 17% VAT rate
	- 17% tax refund rate for exports reduced to 13% as of January 1, 2004	- 17% tax refund rate for exports reduced to 13% as of January 1, 2004	- 17% tax refund rate for exports reduced to 13% as of January 1, 2004
	- 13% tax refund rate for exports increased to 17% as of November 1, 2004	- 13% tax refund rate for exports increased to 17% as of November 1, 2004	- 13% tax refund rate for exports increased to 17% as of November 1, 2004
Preferential Enterprise Income Tax Policies	Five-year full exemption and five-year 50% reduction upon approval from the local tax bureau	Five-year full exemption and five-year 50% reduction upon approval from the local tax bureau	Five-year full exemption and five-year 50% reduction upon approval from the local tax bureau
Preferential Customs Duties and Import-related VAT Policies	Exemption from customs duties and import-related VAT with respect to its imported equipment, spare parts and raw materials	Exemption from customs duties and import-related VAT with respect to its imported equipment, spare parts and raw materials	Exemption from customs duties and import-related VAT with respect to its imported equipment, spare parts and raw materials

Preferential Time Limit for Depreciation of Equipment Used in Production (applicable to foreign investments exceeding US$30 million)	- No less than three years- According to industry standards, SMIC Shanghai uses 10-year basis	- No less than three years- According to industry standards, SMIC Beijing uses 5-year accelerated basis	- No less than three years- According to industry standards, SMIC Tianjin uses 5-year basis

Operating Results

Sales

We generate our sales primarily from fabricating semiconductors. We also derive a relatively small portion of our sales from the mask-making and wafer probing services that we perform for third parties separately from our foundry services.

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In 2005, fabless semiconductor companies accounted for 44.0%, IDMs accounted for 52.4% and systems and other companies accounted for 3.6%, respectively, of our sales. Although we are not dependent on any single customer, a significant portion of our net sales is attributable to a relatively small number of our customers. In 2003, 2004, and 2005, our five largest customers accounted for approximately 57.0%, 59.1%, and 64.0% of our sales, respectively. Our two largest customers in 2003, Samsung Electronics and Texas Instruments, accounted for approximately 12.1% and 11.7% of our sales in that year, respectively. Our two largest customers in 2004, Broadcom and Fujitsu accounted for approximately 13.4% and 12.7% of our sales, respectively. Our two largest customers in 2005, Infineon and Broadcom accounted for approximately 25.8% and 14.7% of our sales in that year, respectively.

The semiconductor industry generally experiences seasonality in which sales are strongest in the third quarter and weakest in the first quarter. This is driven by the seasonal demand fluctuations for the products that incorporate semiconductors. Our rapid capacity ramp-up has significantly outweighed any effects from this seasonality. Once our initial capacity expansion stabilizes, however, we may be more susceptible to these seasonal changes in demand.

Cost of sales

Our cost of sales consists principally of:

- depreciation and amortization;
- overhead, including maintenance of production equipment, indirect materials, including chemicals, gases and various types of precious and other metals, utilities and royalties;
- direct materials, which consist of raw wafer costs;
- labor, including amortization of deferred stock compensation for employees directly involved in manufacturing activities; and
- production support, including facilities, utilities, quality control, automated systems and management functions.

As an increasing portion of our equipment has come on line, our depreciation expenses attributable to cost of sales have gradually increased from US$37.6 million in 2002, to US$172.7 million in 2003, to US$387.5 million in 2004 and to US$661.0 million in 2005.

Operating expenses

Our operating expenses consist of:

Research and development expenses. Research and development expenses consist primarily of salaries and benefits of research and development personnel, materials costs, depreciation and maintenance on the equipment used in our research and development efforts, and contracted technology development costs. Research and development expenses also include costs relating to pilot production activities prior to the commencement of commercial production.

General and administrative expenses. General and administrative expenses consist primarily of salaries and benefits for our administrative, finance and human resource personnel, commercial insurance, fees for professional services, foreign exchange gains and losses from operating activities and costs incurred in connection with developing production capabilities at new fabs, including facility costs and employee costs. Foreign exchange gains and losses relate primarily to period-end translation adjustments due to exchange rate fluctuations that affect payables and receivables directly related to our operations.

Selling and marketing expenses. Selling and marketing expenses consist primarily of salaries and benefits of personnel engaged in sales and marketing activities, costs of customer wafer samples, other marketing incentives and related marketing expenses.

Amortization of deferred stock compensation expenses. Amortization of deferred stock compensation expenses relates to stock compensation for those employees who are not directly involved in manufacturing activities and who receive incentives in the form of options on the shares of our company. Deferred stock compensation expenses are the excess of the deemed fair value of shares over the option exercise price at the time of grant, and are amortized on a straight-line basis generally over the four-year vesting period.

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Other income (expenses)

Our other income (expenses) consists of:

- interest income, which has been primarily derived from cash equivalents and short-term investments and interest on share purchase receivables;
- interest expenses, net of capitalized portions and government interest subsidies, which have been primarily attributable to our bank loans and the imputed interest rate on an outstanding interest-free promissory note; and
- other income and expense items, such as those relating to the employee living quarters and school; and
- foreign exchange gains and losses relating to financing and investing activities, particularly forward contracts.

Comparisons of Results of Operations

Consolidated Financial Data

The summary consolidated financial data presented below as of and for the years ended December 31, 2003, 2004 and 2005 are derived from, and should be read in conjunction with, and are qualified in their entirety by reference to, our audited consolidated financial statements, including the related notes, included elsewhere in this annual report. The selected consolidated financial data as of and for the years ended December 31, 2001 and 2002 are derived from audited consolidated financial statements not included in this annual report. The summary consolidated financial data presented below has been prepared in accordance with U.S. GAAP.

Beginning in the first quarter of 2005, we have retroactively reclassified certain expenses to disclose financial performance in a manner consistent with the practices of other high-tech companies. All figures presented herein have given effect, where applicable, to this reclassification. Due to the significant increase in the intangible assets resulting from the settlement of the litigation with TSMC, amortization expenses, previously classified in cost of sales and research and development have been reclassified into a single line item, amortization of intangible assets under operating expenses. We believe the reclassification improves the presentation of our financial results and provides more meaningful information to investors. The impact of the reclassification for the years ended December 31, 2004 and December 31, 2003 resulted in a decrease of cost of sales of US$5.