

## 2001 business review

# business environment

### Renewed economic weakness

The year 2001 saw a steady deterioration in prospects for a recovery in Hong Kong, as economic conditions in the United States and other major markets worsened. Although the terrorist attacks of September 11 were a tragic and dominant event, the US economy had begun to show signs of slowing as early as March. Not until the end of the year did interest rate cuts seem to slow the decline.

The situation inevitably affected Hong Kong, with our open marketplace and large trade flows with the United States. Despite continued strong growth in mainland China, domestic exports and re-exports decreased respectively 15.2% and 4.6%. Tourism was affected, with air passenger numbers flat.

Hong Kong also continued its economic adjustment brought about by the Asian financial crisis and the currency peg. The consumer price index fell 1.6%. Despite lower interest rates, uncertainties discouraged business investment and reduced employment. The local stock market was among the worst performers of major markets, closing the year down 25%. In this climate, consumer confidence and spending remained understandably weak. Hong Kong's GDP rose 0.1%, after rising 10.5% in 2000.

### Rail expansion remains desired goal

Despite the weak economy, total public transport demand rose moderately to 4,017 million, although the weak economy and continued strong competition saw MTR's market share fall marginally from 24.1% to 23.5%. The market share of the Airport Express Line declined from 28% to 27% in 2001, affected by fewer tourist arrivals from developed countries.

The longer-term trend for Hong Kong to favour railway over other transport modes remains firmly in place, however, especially given the increasing demand for better air quality.

The Government's Railway Development Strategy 2000 states that railways will form the backbone of the future transport system. Six new lines have priority, including the North Island Link, West Island Line and Shatin-Central Link. This aims to bring 70% of Hong Kong people within one kilometre of a station and raise railway's overall share of public transport from 31% in 2000 to 43% in 2016.

### A challenging property sector

The Hong Kong property market remained weak throughout the year. Affordability improved, but rising unemployment, job worries and oversupply weighed heavily on the market. Activity picked up later in the year as interest rates bottomed, allowing transactions to rise marginally from 85,774 units in 2000 to 88,190.

Companies continued to set up regional operations in Hong Kong, which drove demand for quality office space. This was largely offset by shrinking demand overall, owing to poor business conditions and cutbacks in sectors such as technology and finance. As a result, the rise in rental rates in 2000 was reversed, which also pushed down capital values.

Although consumer sentiment and spending remained weak throughout the year, the retail property sector was relatively stable, holding on to rental gains achieved since mid 1999. Larger, higher quality and well-managed shopping centres in good locations have continued to be the main winners in the sector.

# railway operations

MTR continued to make a major contribution to Hong Kong's quality of life and its role as an efficient service hub by providing a safe, reliable, fast and environmentally friendly mass transport service.

### Ridership and revenue

Following an improvement at the end of 2000, there was a decline in the number of people riding on our railway network.

This was due to rising unemployment, a shift of population to the New Territories and increased competition from other modes of transport. Total passenger volumes on the MTR Lines (excluding Airport Express Line) were 758 million, against 767 million in 2000, representing 23.5% of the total market. Our share of cross-harbour traffic fell marginally to 57.4%. Fare revenues from the MTR Lines decreased slightly to HK\$5,164 million.

The Airport Express Line faced greater challenges, especially after the events of September 11. Passenger volumes fell 12.8% to 9.0 million, representing 27% of the airport traffic market. Revenue was not affected and indeed increased as we removed fare discounts. The average fare rose from HK\$53.1 in 2000 to HK\$62.5 in 2001, resulting in revenue of HK\$564 million, an increase of 2.7%.

Innovative marketing initiatives helped ridership, from the "More Time For Life" advertising campaign to the web-based MTR Club, which attracted younger people. Patronage promotions added 3.17 million additional rides.

### Excellent performance

MTR has an Operating Agreement with the Government that sets out minimum performance levels, which are supplemented by our own Customer Service Pledges. We exceeded all these targets. For the year, MTR passenger journeys were 99.9% on time. This means an MTR passenger who travels twice a day and five days a week would on average experience a delay of five minutes or more only once every two years. In the few cases of major service disruption, our staff responded swiftly to assist passengers and ensure services could start again quickly. Escalator and other equipment all recorded excellent reliability figures.

As a result, customer satisfaction was high whilst performance against international benchmarks was more than satisfactory.

### Improving the network

A number of important improvements to trains, stations and customer service was made in 2001.

In December 2000, we increased the train service of the Urban Lines during off-peak hours, followed in mid 2001 by a higher frequency evening peak service. These changes shortened travel time and added to passenger comfort. Early completion of the train modernisation programme also made MTR trains more comfortable, with better lighting and ventilation, improved seats, better displays and additional space for luggage or wheelchair users.

The smooth opening of the new cross-platform interchange between the Kwun Tong Line and the Island Line at North Point Station was another significant achievement. It saves passengers considerable time and resulted in an immediate 1.8% increase in cross-harbour passengers and a 0.6% increase in total passengers.

To enhance customer service, we continued to upgrade station entrances, concourses and control rooms. We also began to install platform screen doors on the Urban Lines to improve the overall environment, energy efficiency and safety. The first installation became operational at Choi Hung in October 2001. MTR is the only company in the world to retrofit platform screen doors to lines already in service.

### Awards

MTR has an excellent track record in all aspects of railway operation from design, construction, commissioning and operation to maintenance.

This was recognised in numerous awards. We were one of only three companies to win "The General Secretariat Award for Innovation in Public Transport" from the International Association of Public Transport (UITP). We were also rated "Best Transport Operator" in the annual survey on the "Performance of Public Transport Institutions in Hong Kong" by the Democratic Alliance for the Betterment of Hong Kong.

In January, MTR was awarded ISO 9001:2001 certification. We were the first Hong Kong company to receive this certification from the Hong Kong Quality Assurance Agency under the revised quality standard.

### Higher productivity and lower cost

Our commitment to exploiting new technologies and adopting best practices helped us reduce total operating costs from HK\$3,663 million to HK\$3,533 million, as we made productivity gains. Business process re-engineering and developing a multi-skilled work force have allowed us to re-deploy staff and reduce manpower. We also outsourced some maintenance and supporting services. Where appropriate, we have also automated operations.

Our Total Station Operation and Total Depot Operation schemes, which involve the gradual merger of operations and maintenance activities at stations and depots, made further progress.

We made cost reductions also in many other areas. We reduced electricity consumption by optimising the train control system and replacing station lighting by more energy efficient devices. We also benefited from rebates offered by the power companies. Our maintenance and asset replacement costs were well contained through a systematic and highly effective asset replacement programme.

### Environment and safety

MTR aims at providing a framework to promote sustainability. We provide equitable access to affordable, safe and reliable transportation while minimising consumption of non-renewable resources, noise and emissions. This leads to lower costs, lower potential liabilities, higher productivity, timely completion of new projects and interest from socially responsible investors.

We strive to make our railways accessible to all – including children, seniors and the physically impaired – with station features such as lifts and ramps, Braille route maps and bi-directional wide ticket gates.

We are committed to ensuring everyone's health and safety on MTR premises. In 2001 our safety records were again among the best in the world for our type of operations. Our Passenger Behaviour and Education programme continued throughout the year. We also ran awards, safety campaigns and participated in Transport Day. We trained employees about safety and refined the system that helps ensure high standards for contractors.

## other businesses

### Octopus contribution up sharply

Octopus Cards Limited continued to build on its success and by year end, 8.2 million cards had been issued, up 15.5% over 2000. Average daily transaction value grew 15% to HK\$47 million. The profit contribution from Octopus Cards Limited surged 123% to HK\$29 million.

The Octopus card system was rolled out to Hong Kong Tramways. More maxicabs and car parks joined and trials were completed on parking meters. Many non-transport organisations also participated, such as Vitasoy vending machines, public swimming pools and Maxim's fast food restaurants. More banks and Circle K convenience stores began offering add value services. These and automatic add-value services on credit cards are promoting greater usage.

### Advertising holds market share

During 2001, we installed 20 trackside video projection systems, which are very popular. Special advertising on station walls and train bodies saw strong demand, helping us retain our more than 50% share of outdoor advertising. Advertising revenue for the year was, however, affected by the weak economy, falling by 15% to HK\$428 million.

A new interactive electronic coupon advertising system, "e-Instant Bonus", allowed advertisers to promote discount offers that could be instantly updated via our data network. We also launched a well-received free weekly magazine.

### Mobile telecommunications usage grows

Total telecommunications revenue fell 0.6% to HK\$173 million. Mobile phone calls rose to 215 million and call minutes to 435 million, but was partly offset by a reduction in paging and payphone use. Rental income from mobile base stations constituted a new source of income.

### Stable rental income

MTR allocates part of its station areas for commercial facilities, at year end totalling 15,124 square metres. These facilities, such as convenience stores, make using the MTR more interesting while providing rental income. During the year we began refurbishing commercial facilities, with new layouts and outlets, while maximising the permitted floor space. Despite the weaker economy, income from this business rose slightly by 2% to HK\$221 million.

### Big consultancy wins

2001 saw a dramatic expansion of MTR's external consultancy business. We won 69 new overseas consultancy contracts worth HK\$71 million and revenues from consultancy rose 300% to HK\$32 million.

We won a contract in Bangkok and four contracts were signed for work in Singapore. Elsewhere, we won new business in Shenzhen, Guangzhou, Kaoshiung, Taipei and Delhi. In Hong Kong, MTR was awarded a contract to operate and maintain the Airport Authority Automated People Mover.

reduce the financial burden on MTR. We also worked with the Government and outside parties to ensure the proper off-site infrastructure will be available.

This work positioned us well for rolling forward our tender programme. When market conditions became more favourable at the end of 2001, we invited tender for Area 55b, a primarily residential scheme which was awarded in January 2002. We will tender more packages during 2002 if market conditions are suitable. The total development area related to the Tseung Kwan O Extension will be around 2.3 million square metres of mixed-use property.

### Other developments

In August we signed a contract with Chun Wo Holdings Ltd. to develop a site above Choi Hung Station, improving the interchange facilities, adding retail and residential units, as well as incorporating public car parking.

We deferred a development above the remaining open-air part of Chai Wan Depot, but continued with plans for a site next to Tsing Yi Station.

### Strong returns from investment properties

Income from investment properties held up well, despite the renovation of two major shopping centres during which retail floor space was taken out of use. The loss of revenue was offset by stronger-than-expected performance of the unaffected areas.

The major upgrading and renaming of Heng Fa Chuen shopping centre as Paradise Mall, with its striking theme, enlarged the catchment area and was near 100% pre-let upon opening. The renovated Telford Boulevard enhanced our successful Telford Plaza mall in Kowloon Bay. Maritime Square, our popular regional shopping centre at Tsing Yi Station, had another good year as we adjusted the mix of outlets.

Looking ahead, we have given significant attention to the design of the 80,000 square metre retail centre Union Square in downtown Kowloon. This is an important development in which MTR will have the majority interest.

### Property Management

MTR is now one of Hong Kong's largest property management companies. By year end 39,613 residential units and 370,022 square metres of office and retail space were under our management. Income from property management rose by 21.7% to HK\$73 million in 2001. This business will increase in the coming years, as more Airport Railway property packages are completed and come under our management.

Tight cost control and high quality services allowed us to retain all existing management mandates. We devised new value-added services for customers and at the same time generated additional revenue for MTR. Our high-end Premier Management, which offers such attractions as 24-hour concierge service, was especially popular.

We introduced personalised Octopus cards for residents for convenient access and for use with other interactive equipment, making us a market leader in this area. We also upgraded our informatics and on-line management services to increase efficiency and to provide better customer services.

### Environment

Market sentiment is creating demand for efficient, well-built and "green" developments. We have demonstrated our commitment to an environmentally friendly approach with our innovative planning for the Area 86 site at the future Tseung Kwan O South Station. With its segregation of pedestrians and vehicles, extensive open space and recreational facilities, accessibility and all necessary supporting community services, Area 86 will become the largest and best planned environmental town in Hong Kong.

## property review

Our property is developed in cooperation with well-known property developers who bid in open tender for projects. We minimise downside financial risk to MTR through up-front payments from developers, profit-sharing, sharing of asset-in-kind or back-end profit. We also keep investment properties for rental income and manage properties for ourselves or other owners.

Despite a weak market overall, MTR recognised HK\$3,248 million in property development profits in 2001. We also achieved income growth from investment property and property management.

### Airport railway schemes popular

The Airport Railway developments completed during the year accounted for a significant part of total SAR property sales. Completed properties became available in the Tung Chung, Olympic and Kowloon Station packages, including highly regarded residential developments such as Caribbean Coast and

Sorrento. Despite the weak market, total sales of 12,700 units were recorded by year-end. This demonstrates that MTR locations remain highly attractive because of their convenience and good planning.

Our commercial schemes also progressed well. Bank of China purchased a 28,000 square metre office block at Olympic Station and the Hong Kong Monetary Authority agreed to buy approximately 30,000 square metres of offices in International Finance Centre Tower 2.

We continued to work closely with developers and the Town Planning Board to refine schemes in order to add value, reduce costs and improve marketing prospects. A notable example is the Kowloon Station development, which we renamed Union Square.

### Tseung Kwan O all set for 2002

The Tseung Kwan O Extension saw good progress in the works needed to prepare for property development. As in all our schemes, we minimised these works to limit front-end costs and

## strategies for the future

The Government has made a clear policy commitment to develop Hong Kong's railway infrastructure. In line with this policy, we are planning and building new lines that will generate future fare revenue and property income for the Company.

### Tseung Kwan O Extension ahead of schedule, below budget

The Tseung Kwan O Extension, which will bring areas of the new town into the MTR network, is currently ahead of schedule and is expected to begin operations in August 2002, with a final cost more than 40% below its original budget. The line will carry an estimated 56,000 passengers per hour per direction in the peak hour and will result in the building of 2.3 million square metres of mixed-use property.

### Shatin-Central Link under consideration

In January 2001, the Government invited MTR to submit a competitive tender for the Shatin to Central Link. Nearly 50 people worked for six months on the proposal, which was submitted in July 2001.

Our proposal is keenly competitive in respect of cost and programme. To enable us to secure a commercial return on our investment, our proposal also includes a small amount of property development. We stated the new link could be open by 2008.

We are awaiting the Government's decision on this tender.

### Progress on Penny's Bay Rail Link and Island Line Extensions

Construction work is planned to begin in mid 2002 on the Penny's Bay Rail Link that will connect Hong Kong Disneyland with the MTR. This involves building a new station at Yam O, connecting with the Tung Chung Line. In conjunction with this rail link to the new Hong Kong Disneyland, a tourism-related commercial development of around 100,000 square metres of gross floor area is proposed adjacent to the future Yam O Station.

Our proposals for the North Island Link and West Island Line are under consideration by the Government. The North Island Link will connect the Tung Chung Line to the Island Line at Fortress Hill. The West Island Line will extend the network to Kennedy Town. We aim for completion between 2008 and 2012.

### Tung Chung cable car

We have been shortlisted by the Government in a tender to build a cable car system on Lantau Island linking Tung Chung with Ngong Ping and the nearby Big Buddha Statue and Po Lin monastery. The scheme foresees a major new tourist landmark harmonising with the surroundings.

Over one million people are expected to use the cable car in its first year, boosting ridership on the Tung Chung Line. We look to complete the project by 2005.

### Towards a true "world city"

We are working to ensure Hong Kong continues to benefit from a world-class, environmentally friendly public transit system by improving the integration of the MTR network and with other modes of transport. To this end, we are examining less expensive above ground light rail links.

Pedestrianisation and better pedestrian links between MTR stations and neighbouring buildings would increase the attraction of MTR stations. Hong Kong needs more pedestrianisation to make the city truly a "world city". We continue to work hard to create pedestrian links with MTR stations, as between Causeway Bay and Times Square. Two connections within the MTR network will be added in 2002 and work has since begun on two more for completion by 2003. A further eight links are being studied.

## human resources

MTR's culture enables us to attract, retain and develop high calibre people at all levels. Our achievements in this area were recognised by the "Good People Management Award 2001" from the Hong Kong SAR Labour Department.

In 2001, we focused on raising productivity while maintaining high levels of job satisfaction. Staff costs have fallen continuously since 1998 and a hiring freeze is in place. We have achieved cost savings through some staff reductions, balanced by the development of a multi-skilled workforce, redeployment and outsourcing. These initiatives have contributed to better job satisfaction and harmonious labour relations.

We have steadily improved employee communications and training. New equipment also helped improve training in 2001.

So too did revised training methods, some of which received awards.

In 2001 we officially launched our Core Values of Service, Respect and Value to help foster a strong culture of continuous improvement among our people. Our fourth Staff Attitude Survey showed that our employees strongly support MTR and identify with our objectives.

The MTR's recently published Code of Conduct covers employees, customers, contractors, the community, as well as health and safety. The code applies to all employees and aims to ensure consistently high standards of care and fair treatment – from excluding conflict of interests to transparency towards customers.

## financial review

### Financing achievements

During 2001, we capitalised on our good standing in the financial market to complete a sizeable financing programme at reduced costs to fund our expansion and to refinance existing debt. We continue to maintain a solid balance sheet whilst our high credit ratings have been raised or reaffirmed.

### HK\$16 billion debt raised

MTR completed a borrowing programme totalling HK\$16 billion during 2001. The proceeds were used to refinance less cost-effective facilities and to cover the remaining funding requirement for the Tseung Kwan O Extension and other projects.

High liquidity and low borrowing costs in Hong Kong led us to focus on the local market. Of the total, HK\$11 billion was in the form of bank loans at very fine rates, some with maturities of up to seven years. The domestic bond market also offered excellent opportunities and MTR arranged a total of HK\$5 billion in medium term notes at very attractive costs.

As at the year-end we had a total of HK\$5.5 billion in credit facilities that we have not yet used. These are sufficient to cover our anticipated funding needs up to the first quarter of 2003.

### Borrowing costs reduced

Improved borrowing terms and lower interest rates reduced our average interest cost from 7.8% to 6.6%. We continued to minimise interest rate risk by maintaining a conservative mix of fixed and floating rate debt. Through our Preferred Financing Model we diversify all types of risk and we use derivative instruments only to hedge and not to speculate, dealing only with counterparties enjoying high credit ratings.

### Strong credit ratings

We were the first Hong Kong corporate borrower to obtain international credit ratings and have since been on a par with the Hong Kong Government. Despite the difficult business environment in 2001, MTR's strong credit fundamentals have continued to receive high recognition from international rating agencies. During the year, MTR's domestic/foreign currency ratings were raised to AA-/A+ by Standard & Poor's and Aa3/A3 by Moody's, well above investment grade and among the highest in Asia.

### Financing capacity strengthened

Successful planning and implementation has reduced the estimated cost of the Tseung Kwan O Extension project. Other new projects were also streamlined. Our estimated capital expenditure programme over the next three years has fallen to HK\$10.6 billion. This leaves MTR with significant extra financing capacity.

We will continue our strategy of supplementing returns on railway investment with property developments, to help mitigate the impact of increased depreciation and interest charges on new railways.

### Review of financial results

#### Profit and loss

**Total fare revenue** for the MTR Lines amounted to HK\$5,164 million, marginally below 2000's HK\$5,166 million. The average fare increased from HK\$6.73 in 2000 to HK\$6.81, mainly as a result of the full year effect of the additional 10 cents per ride charged since July 2000 to fund the platform screen doors project and increased length of average journey. Non-fare revenues increased from HK\$1,862 million to HK\$1,864 million.

**Operating expenses** before depreciation decreased by 3.5% to HK\$3,533 million. Staff costs were again reduced, from

HK\$1,688 million to HK\$1,641 million, reflecting higher productivity and staff redeployment. Other operating costs decreased by 4.2% owing to lower maintenance costs. As a result of lower costs, operating profit from railway and related operations before depreciation was up 3.7% to HK\$4,059 million. This represented a margin of 53.5% on total revenue and was the highest since 1998.

**Profit on property developments** amounted to HK\$3,248 million, compared with HK\$3,376 million in 2000, mainly due to the recognition of deferred income and sharing of profits in respect of certain Airport Railway developments.

**Operating profit before depreciation**, buoyed by the solid results from railway and property, increased marginally by 0.2% to HK\$7,307 million. Depreciation and amortisation charges, however, rose 4.2% to HK\$2,178 million, following the completion of the Quarry Bay Congestion Relief Works project. As a result, operating profit after depreciation was 1.3% lower at HK\$5,129 million. Against this, net interest expense fell from HK\$1,143 million to HK\$874 million, reflecting lower interest rate.

**Net profit** for the year increased from HK\$4,069 million in 2000 to HK\$4,284 million. Earnings per share were HK\$0.85 and the Board has recommended a final dividend of 28 cents per share for the year.

#### Balance sheet

**Total fixed assets**, mainly the railway system and investment properties, increased from HK\$78,475 million to HK\$79,243 million mainly as a result of railway improvement works.

**Total loans outstanding** were HK\$31,385 million, an increase of HK\$4,182 million, mainly to finance the Tseung Kwan O Extension and other capital works. The debt-to-equity ratio increased from 54.0% to 58.1%, in line with our longer-term financial plan, while interest cover – the ratio of pre-depreciation and pre-interest profits to total interest payments – remained at a satisfactory level of 3.8 times, the same as last year.

**Deferred income** decreased from HK\$10,403 million to HK\$8,411 million as amounts were recognised as profit in line with progress of construction and pre-sales of relevant property developments.

**Total shareholders' funds** stood at HK\$54,049 million, an increase of HK\$3,694 million mainly due to increase in retained profit and shares issued from scrip dividends.

#### Cash flow

**Net cash inflow** from operating activities increased slightly to HK\$4,155 million due to higher revenues and lower operating expenses. The main cash outflow related to the Tseung Kwan O Extension and other capital works, together with interest and dividend payments, amounted to HK\$8,312 million. The resulting cash shortfall was satisfied mainly by increased loan drawdown.