Business review 2002

business environment

Recovery postponed

The year 2002 began with anticipation of a significant turnaround in the world economy and financial markets. In the event, a series of accounting and governance scandals in the United States, coupled with terrorism and escalating tension with Iraq, badly undermined confidence. Major stock indices fell sharply. Investor sentiment and business investment remained weak. Consumers reined in spending.

Hong Kong additionally experienced further structural adjustment, unleashed by the bursting of its asset bubbles and China's rapid integration into the world economy. Average residential property prices fell another 6% and the *Hang Seng Index* finished the year 18% lower. Consumer prices saw their fourth consecutive year of decline. Unemployment rose to 7.8%, its highest level since 1981. Consequently, consumer demand and investment growth were weak, despite ample banking liquidity and record low interest rates.

Hong Kong nevertheless benefited from Mainland China's impressive performance. Air cargo volumes and container throughput rose strongly. Exports and re-exports registered combined growth of 5.4%. Tourism was boosted by Mainland visitors. As a result, Hong Kong registered 2.3% GDP growth for 2002, against 0.6% in 2001.

Transport benefits from more visitors

After modest growth of 1.5% in 2001, the franchised public transport industry posted a 2.1% increase in 2002.

Total public transport demand for the year was 4,083 million journeys, up from 4,017 million in 2001, of which franchised operators carried 3,347 million. Despite strong competition, MTR's market share was maintained at 23.5% with the opening of the Tseung Kwan O Line.

Overseas tourist arrivals increased by 20.7% to 16.6 million, owing to a 53.4% surge in Mainland visitors. Air passenger traffic rose 2% to 23.5 million. The market share of the Airport Express Line fell marginally from 27% to 25%, however, due to the elimination of the10% fare discount.

Property remains weak

Property prices and rentals continued their downward adjustment. Office demand remained weak as financial firms cut back on space requirements. Leasing activity was very subdued, with little demand for new space. New supply put pressure on rents, which fell substantially. The retail sector suffered from the poor economy and an outflow of shoppers to the Mainland. The residential market was affected by worsening sentiment and an overhang of supply, and the value of transactions decreased by 3.8% from 2001 to HK$185 billion, marking a 12-year low.

The Government's new housing policy, announced in November, officially ends the 70% home ownership target set in 1997 and includes the suspension of land auctions and development tenders by Hong Kong's railway companies in 2003.

Despite this, little immediate improvement is expected. The office sector needs higher business volumes in financial services. Brighter employment and earnings prospects are required to buoy the residential market. The retail sector may, however, see some improvement, as the price differential with Shenzhen narrows.

railway operations

In August, the new Tseung Kwan O Line extended the MTR's safe, reliable, fast and environmentally friendly service to eastern Kowloon. As a result, patronage on MTR rose, which combined with cost controls contributed to higher operating margins and profitability.

Higher patronage

A key challenge in 2002 was to maintain ridership and revenues. We achieved this through continuous service improvements and fare incentives designed to retain existing passengers and attract new ones.

The opening of the Tseung Kwan O Line in August boosted ridership in 2002, with the MTR Lines recording total passenger volume of 777 million, against 758 million in 2001. This represents 23.5% of the total franchised public transport market, the same as for 2001. The Company increased its share of cross-harbour traffic to 58.2%. Fare revenues from operations rose marginally to HK$5,167 million from HK$5,164 million.

On the Airport Express Line (AEL), the discontinuation of fare discounts led to lower passenger volume, which fell 6.3% to 8.5 million, representing 25% of the total market. The average fare, however, rose from HK$62.50 in 2001 to HK$65.43 in 2002. Fare revenues were recorded at HK$553 million, a small decrease of 2.0% from 2001.

A core strategy was to promote better linkage between MTR and other transport services. The trial inter-modal fare discount scheme, which gives feeder bus passengers discounted bus fares, was extended to Tung Chung, Discovery Bay, Tseung Kwan O and Kwun Tong. We installed dedicated bus stops in Western District for all potential MTR feeder bus routes and Citybus reorganised routes accordingly. To coincide with the opening of the Tseung Kwan O Line, feeder buses were introduced on several bus and minibus routes. A discount was offered to passengers using the new stations during the first two weeks.

To provide greater incentive to passengers with longer walks to MTR stations, "Fare Saver" machines were installed in five shopping arcades, offering fare discounts via Octopus Cards. Other fare promotion schemes included shareholder discounts on AEL, while new ticket types were introduced on AEL for groups, children, students, seniors and tourists.

In October, MTR inaugurated a morning express service from Tsing Yi to Central on the Airport Express Line, using the highly comfortable Airport Express trains.

High reliability

The opening of the Tseung Kwan O Line four months ahead of the original schedule was a major achievement. Despite initial teething problems, the service has received much praise and brings an additional 150,000 plus passengers daily into the MTR system.

Overall, the Company maintained its very high standards of safety, reliability, comfort, and customer satisfaction in 2002, surpassing the levels required by the Government's Operating Agreement and the MTR's more stringent Customer Service Pledges. Of particular note, MTR's safety performance has been on an uptrend for three consecutive years since 1999.

The reliability of fare collection equipment and tickets increased, while that of other equipment remained high. This contributed to high levels of customer satisfaction. In 2002, the Service Quality Index for the MTR and AEL stood at 68 and 82 respectively on a 100-point scale. MTR also performed well according to the 10-member Community of Metros (CoMET) report.

Enhanced service

MTR devotes considerable effort to improving its infrastructure and services to maintain high levels of customer satisfaction, reliability, patronage and operating efficiency.

In 2002, commissioning of a new Station Management System was completed in twelve stations. The system integrates different station control equipment and systems, simplifying the operational process, enhancing efficiency and reducing the likelihood of human errors.

The extensive station improvement project, designed to create a brighter, more modern appearance, saw new entrances added at two stations and additional escalators and lifts at four stations. Installation of platform screen doors continues and was completed at five stations. Throughout this process, MTR achieved timely completion without affecting train service reliability.

The signalling system was improved through a new system that gives flexibility to operations staff to control train service whilst assuring the highest safety levels. We also installed new trackside signalling for the Tseung Kwan O Line. Improvements were made to track reliability and ride, as well as train energy efficiency and noise emission.

Electronic display boards were installed in all stations, displaying important safety and train service information as well as other information such as weather conditions, the air pollution index and advertisements. Additions were also made to the Company's Art in Stations initiative, making journeys more enjoyable for a wider range of passengers.

Increased productivity

MTR continued to make gains in productivity, supported by a hiring freeze and its multi-skilled workforce. Maintenance services for the Tseung Kwan O Line were successfully outsourced. We also completed implementation of the "total operation" approach to station and depot management, which has trimmed costs without compromising safety or service quality. Energy conservation initiatives included lighting rewiring at our headquarters and traction energy savings through Automatic Train Regulation and timetable improvement. Standardising station furniture design has lowered installation and maintenance costs.

other businesses

Many of our non-fare businesses performed well in 2002 despite the difficult environment.

Strong results from Octopus Cards

Octopus Cards Limited went from strength to strength, with cards in circulation and service providers increasing, and total daily transaction value reaching HK$50 million. Minibuses accepting Octopus nearly doubled to 2,300, while car parks increased from 33 to 85, and the scheme was introduced on cross border shuttle services. Large retail chains which fully launched Octopus included Park'n Shop, Watson's, Circle K and Café de Coral. Octopus applications on campus were enriched by the introduction of mobile phone messages to parents. Moreover, property access control via Octopus expanded to the commercial sector and more residential properties were added, including Mainland China.

The profit contribution from Octopus Cards Limited rose to HK$39 million in 2002, 34.5% higher than 2001.

New advertising opportunities

During 2002, two new journals for MTR patrons provided additional scope for advertising. The 265,000 daily circulation *Metro* newspaper reaches 550,000 readers. *Recruit* magazine was replaced by *Jiu Jik*, with 180,000 copies twice weekly. Enlarged concourse poster panels and improved trackside advertising panel lighting added to the network's attraction.

Affected by the weak economy, advertising revenues fell by 6.8% to HK$399 million.

Looking to fixed line in telecoms

Revenues from mobile telecommunications increased and we began to explore areas such as 3G and wireless LAN. Wholly-owned subsidiary TraxComm Limited was established, to exploit liberalisation of the fixed network telecommunication market, targeting new operators and service providers.

Telecommunications revenue rose 7.5% to HK$186 million.

Higher station commercial revenues

By year end, 17,405 square metres of station floor area were allocated for commercial facilities, 2,281 square metres more than in 2001. A major achievement was the on-time opening of all retail units along the Tseung Kwan O Line. In addition, we completed renovation of Central and Kowloon Bay stations and added trades, including take-away food and beverages. Throughout this work we minimised the impact on patrons.

A marginal decline in average rents was more than offset by volume increases, and income from station commercial properties rose 7.7% to HK$238 million.

Impressive growth in consulting

During 2002, we secured consultancy contracts in Shanghai, Tianjin, Nanjing and Shenzhen in Mainland China as well as Taipei and Kaohsiung in Taiwan. We also established four overseas offices and secured a further three-year plus three-year option operation and maintenance contract for the Automated People Mover system at Hong Kong International Airport, extending our involvement until 2008.

Revenues from consultancy rose 96.9% in 2002 to HK$63 million.

property review

The development of properties linked to the MTR network has played an important role in creating new living and working communities in Hong Kong. The property market remained weak in 2002 and MTR's improved results reflect the strength of this approach. We work in joint venture with experienced developers and combine excellent locations with a high quality of design, finish and management.

Strong property development gains

Securing the commitment of developers at projects along the Tseung Kwan O Line and the launch of major residential projects along the Airport Railway, together with continued construction progress, resulted in a 15.6% increase in property development profit over 2001 to HK$3,755 million.

Three residential projects totalling 4,025 flats were launched along the Airport Railway to a positive market response: Phase 1 of Coastal Skyline and Seaview Crescent at Tung Chung Station and Phase 2 of Sorrento at Kowloon Station. Other Airport Railway development sales included Phase 1 of Sorrento at Kowloon Station, Island Harbourview, Central Park and Park Avenue at Olympic Station, and Tung Chung Crescent and Phase 1 of Caribbean Coast at Tung Chung Station. Construction at Kowloon and Tung Chung stations progressed according to plan, with 6,382 flats obtaining occupation permits. In response to changing market conditions and forecasts, adjustments were made to several schemes, to improve marketability and add value.

Construction progressed on the 88-storey Two International Finance Centre (Two IFC) at Hong Kong Station and by year-end, the curtain wall reached the 69th floor. Completion is scheduled for mid-2003 and marketing began for the MTR's 18 floors, located on levels 33 to 52, branded "Central 18 Zone at Two IFC". We have entered into initial discussions with several potentially large tenants. We also prepared the pre-lease marketing for the new retail centre at Union Square, MTR's fifth shopping centre.

Along the Tseung Kwan O Line, property development rights were awarded for three new residential projects: Area 55b in Tseung Kwan O Station to a consortium led by New World Development Company Limited; the Hang Hau Station development to a consortium of Sino Land Company Limited and Kerry Properties Limited; and the Tiu Keng Leng Station development to Cheung Kong (Holdings) Limited.

In May, the Agreement for Lease was signed for Area 86 in Tseung Kwan O, an extensive development that will contain some 21,500 flats in a garden environment to become Hong Kong's first-ever "green city".

The Town Planning Board approved a further 1,132 square metres gross of residential space at the Choi Hung Park and Ride Development, in addition to the 2,122 square metres gross of bonus floor area previously approved.

100% occupancy at investment properties

Our shopping centres performed well, despite the economic pressure on retailers and landlords. Rentals and retail sales recorded strong growth, resulting in a 9.8% increase in rental income to HK$897 million.

We maintained a 100% occupancy rate at Telford Plaza, Maritime Square, Paradise Mall and Luk Yeung Galleria. This results from our close partnerships with retailers, who we support through strategic promotional campaigns.

Our "Total Quality Service Regime" programme was well received by tenants, who recognised its relevance in today's competitive conditions. It aimed to raise awareness of the importance of service quality, increase competitiveness through implementing industry-leading service standards and establish benchmarks to promote better tenant selection and management.

Expanded property management and agency portfolio

Income from property management rose 16.4% to HK$85 million, the result of managers' remuneration income from newly completed Airport Railway properties and income from other property management services.

Our property management-related business continued to expand and diversify, bringing into its portfolio a total of 2,461 residential flats at the Olympic Station's Central Park development and Seaview Crescent in Tung Chung Station, thereby increasing residential units managed to 42,074 from 39,613, in addition to 370,022 square metres of retail space.

The Octopus Card Building Access Control system was adopted in commercial car parks at three MTR shopping malls and at One International Finance Centre, as well as all Airport Railway residential developments. This system now extends to properties not managed by MTR.

MTR Property Agency Company Limited, our one-stop service to residents of the developments we manage, added HK$5 million in revenue.

Breaking into overseas markets

We took our first successful steps in capitalising on our property skills outside Hong Kong.

In Shenzhen, we signed contracts to manage the East Pacific Garden Clubhouse and the King's Lodge residential development. We also provided pre-leasing and pre-management advisory services to East Pacific (Holdings) Limited, the developer of East Pacific Garden, and pre-management advisory services to Beijing Century Sun Real Estate Development Company for its Palm Springs International Apartments in Beijing.

In Singapore, we won our first property development consultancy contract. MTR was selected by the Land Transport Authority to provide consultancy services for the packaging and marketing of a site above a proposed Singapore Mass Rail Transit station.

future projects

The MTR's vast rail expertise is being applied to rail extensions, associated property developments and other projects. For every project, MTR conducts detailed evaluations of viability and cost, in partnership with contractors. The Tseung Kwan O Line, which opened in August 2002 four months ahead of schedule and HK$14.5 billion below original budget, powerfully demonstrates the effectiveness of our project management style.

Work begun on Penny's Bay Rail Link

In July, the Company signed the project agreement with the Government for the 3.5-kilometre Penny's Bay Rail Link to the Hong Kong Disney Theme Park. The HK$2.0 billion project involves a new station at Yam O in North East Lantau, as an interchange with the Tung Chung Line. We target completion by July 2005, comfortably ahead of the theme park opening.

Foundation work for Yam O Station is underway, together with preparatory work for the Tai Yam Teng tunnel connection, and all major engineering contracts have been awarded, including those for Disneyland Station. To save costs, we will convert some existing MTR trains for the rolling stock.

Preparing for the Tung Chung Cable Car

Also in July, the Provisional Project Agreement was signed with the Government for the Tung Chung Cable Car project. This HK$750 million project will link Tung Chung with Ngong Ping, the nearby Big Buddha and Po Lin Monastery. Construction is planned to start in August 2003 and be completed by August 2005. MTR has signed a memorandum of understanding for the operating and maintenance contract, and has tendered or awarded all other major consultancies and contracts.

Tung Chung Line ridership should be boosted by the facility, which is forecast to attract 1.25 million people in its first year. MTR will also derive revenue from the terminal complexes, with commercial areas totalling 16,000 gross square metres.

Planning for the Island Line Extensions

In January 2003, the Government announced its decision to allow MTR to proceed with the planning of West Island Line Phase 1 and the South Island Line, while deferring the North Island Link.

The West Island Line will extend the MTR network beyond Sheung Wan, by 2009 to Sai Ying Pun and Belcher Station, and later to Kennedy Town. From a proposed interchange at Belcher Station, the South Island Line envisages seven intermediate stations from Cyberport to Happy Valley before connecting with the Island Line at Wan Chai. The North Island Link would extend the Tung Chung Line from Hong Kong Station to connect with the Island Line at Fortress Hill.

Concepts for transit links

MTR has also been planning for less expensive, environmentally friendly above-ground light rail links that would extend MTR's services into less densely populated areas. In 2002, we submitted a concept to the Government for an Environmentally Friendly Transport System to serve the Kai Tak redevelopment area, connecting with Ngau Tau Kok Station on the Kwun Tong Line.

More pedestrianisation

Pedestrianisation of streets adjacent to MTR entrances and pedestrian links increase the attraction of MTR stations and support patronage. Over a dozen such schemes have been completed in co-operation with private developers, the Urban Renewal Authority, the Housing Authority and other bodies. In 2002, work began on pedestrian links at Mong Kok and Kwun Tong stations, both to be completed in 2003, with three more projects planned for later in 2003.

human resources

MTR recognises the vital role played by its employees in contributing to its continuous success in operations and new business development, and in 2002 launched initiatives that contributed to higher productivity, enhanced performance orientation as well as leadership and staff development.

Enhancing productivity

Our consistent ability to enhance the value of our human assets was exemplified in the opening of the new Tseung Kwan O Line. A Corporate Staff Redeployment Programme was launched to redeploy employees voluntarily across disciplines and departments, resulting in higher productivity and promoting a multi-skilled workforce. The staffing requirement of the new line was met entirely via redeployment within a short time frame and in support of this, 45,000 trainee days were recorded for the year.

Productivity was further enhanced by implementation of phase two of our comprehensive Human Resource Management System, which covers all employees, contains interactive features and provides timely employee information to managers and staff. The performance-oriented culture at MTR was reinforced by the introduction of a more rigorous performance-based pay review mechanism for general staff.

Leadership development

To groom talent for future leadership needs, a Manager Accelerated Development Programme was launched. This broadens managers' experience and exposure through specially designed training modules and action learning projects.

Leveraging human resources expertise

With a broad base of expertise in railway related training, MTR's human resource and training departments support the Company's external consulting role through provision of its professional railway operations training packages and strategic human resource management services.

financial review

Financing achievements

Groundbreaking retail bond

2002 saw continuing strong liquidity in the Hong Kong dollar debt market and the rapid development of its retail bond market. We took advantage of this to become the first Hong Kong listed company to launch a retail bond in May, attracting record subscriptions of more than HK$5.6 billion from over 18,000 applicants. The issue size was increased from HK$1.0 billion to HK$3.5 billion. At year-end, MTR had undrawn committed banking facilities totalling HK$6 billion, sufficient to cover its forward funding requirements until early 2004.

Lower borrowing costs

Lower interest rates and MTR's ability to secure cost effective funding helped reduce the Group's average borrowing cost from 6.6% in 2001 to 5.4%, resulting in a HK$157 million reduction in gross interest expense. Interest expense charged to the profit and loss account, however, increased from HK$874 million to HK$1,125 million in 2002 as, following the opening of the Tseung Kwan O Line, related borrowing costs were no longer capitalised to the project.

Sound risk management

The Company continued to manage its financing activities and debt portfolio on a prudent basis in accordance with its well-established Preferred Financing Model, resulting in a well-diversified debt portfolio being maintained throughout the year in terms of maturities, type of instruments, as well as currency and interest rate risks, with adequate forward coverage.

Strong credit ratings

As the first Hong Kong corporate borrower to obtain international credit ratings, MTR maintained strong credit ratings on par with the Hong Kong SAR Government throughout 2002. Our short-term and long-term domestic/ foreign currency ratings were reaffirmed by Moody's at P-1 and Aa3/A3, and by R&I at a-1+ (local currency) and AA/AA-. Standard & Poor's also reaffirmed our long-term domestic/ foreign currency ratings at AA-/A+ and short-term domestic/foreign currency ratings at A-1+/A-1.

Funding capacity for new projects

In July 2002, we were awarded the Penny's Bay Rail Link and the Tung Chung Cable Car projects, with estimated project costs of respectively HK$2 billion and HK$750 million. Taking into account these two projects and other capital works, we anticipate a modest capital expenditure programme between 2003 and 2005 estimated at HK$7.2 billion, and this should leave MTR with sufficient financing capacity to capture future project and investment opportunities.

Review of financial results

Profit and loss

Total patronage for the MTR Lines increased by 2.5% from 758 million in 2001 to 777 million in 2002. Average weekday patronage increased to 2.26 million, compared to 2.23 million. Our overall market share of the Hong Kong public transport stayed at 23.5%, with cross-harbour share increasing from 57.4% to 58.2%.

Total fare revenue for the MTR Lines was HK$5,167 million, slightly higher than in 2001. The average fare decreased from HK$6.81 in 2001 to HK$6.65, as a result of promotions.

Airport Express Line (*AEL*) average daily patronage declined by 9.0% to 23,200 due to the removal of fare discounts and severe competition. Market share of airport passengers fell from 27% to 25%. Total AEL revenue dropped 2.0% to HK$553 million, the average fare increasing from HK$62.5 to HK$65.4.

Non-fare revenues increased by 5.5% to HK$1,966 million, comprising HK$987 million from property rental and management and HK$979 million from station commercial and other revenues.

Operating expenses before depreciation increased by 3.8% to HK$3,672 million due to write-offs of project study and deferred expenditures of HK$218 million in respect of the Shatin-Central Link and North Island Link, partly offset by a HK$68 million reduction in staff cost. Had the write-offs been excluded, the operating expenses before depreciation would have been decreased by 2.0% compared with 2001 despite opening of the Tseung Kwan O Line.

Operating profit from railway and related operations before depreciation was HK$4,014 million, a decrease of 1.0% and representing a 52.2% margin compared with 53.4% (as restated) in 2001.

Profit on property developments was higher at HK$3,755 million, mainly from Airport Railway developments.

Operating profit before depreciation increased by 6.4% to HK$7,769 million. Depreciation and amortisation charges increased by 13.4% to HK$2,470 million following capitalisation of the Tseung Kwan O Extension project costs, and operating profit after depreciation increased by 3.4% to HK$5,299 million.

Net interest expense increased from HK$874 million to HK$1,125 million, as Tseung Kwan O Line interest expenses being charged to the profit and loss account after its opening. Interest cover increased to 4.5 times from 3.8 times last year, however.

Net profit for the year decreased by 1.5% to HK$4,212 million and earnings per share were HK$0.83.

Balance sheet

Total fixed assets increased from HK$79,243 million in 2001 to HK$94,270 million as a result of capitalisation of the Tseung Kwan O Line assets.

Railway construction in progress reduced by 99.2% to HK$109 million, following transfer of Tseung Kwan O Extension project construction costs to fixed assets.

Property development in progress amounted to HK$2,870 million, a reduction of 14.6%, mainly due to the offset of property development costs against upfront payments received from property developers.

Cash and cash equivalents stood at HK$1,718 million compared to HK$215 million, mainly due to proceeds from property sales and upfront payments received from developers in the last quarter of 2002.

Total loans outstanding amounted to HK$33,508 million, an increase of HK$2,123 million, mainly to finance the Tseung Kwan O Extension and ongoing capital works.

Deferred income decreased from HK$8,411 million to HK$6,226 million, as amounts were recognised as profit from developments according to construction progress and pre-sale programmes.

Share capital, at HK$33,910 million, was slightly higher than in 2001, as a result of shares issued from the scrip dividend and share options exercised.

Total shareholders' funds stood at HK$56,827 million, an increase of HK$2,934 million, mainly attributable to retained profits. The gross debt-to-equity ratio increased marginally to 59.0%, in line with our financial plan. However, the net debt-to-equity ratio decreased to 55.9%.

Cash flow

Net cash inflow from operations increased slightly to HK$4,228 million on higher property rental revenues. The main cash outflow related to the Tseung Kwan O Extension and other capital work projects, which together with interest and dividend payments, amounted to HK$7,347 million. The resulting cash shortfall was satisfied mainly by net loan drawdown and receipts from property developers.

* *Note: Comparisons refer to the 2001 financial year. Balance sheet figures refer to 31 December year end.*