Executive management's report

Railway Operations

SARS posed serious short-term challenges to the railway operations, but the small decline in revenue testifies to the subsequent recovery and MTR's effective operations management. Total fare revenues fell by 4% to HK$5,489 million.

Patronage

Patronage fell by up to 25% during the SARS peak but recovered later in the year, helped by traffic on the new Tseung Kwan O Line.

MTR Lines recorded total passenger volume of 770 million, against 777 million in 2002, a 24.3% share of the total franchised public transport market, and a good increase from 2002. This included an increased share of cross-harbour traffic to 58.7%. Fare revenues fell slightly to HK$5,064 million from HK$5,167 million.

Airport Express Line (AEL) patronage declined 19% to 6.8 million. Average fares also fell, from HK$65.43 in 2002 to HK$62.07 with fare revenues dropping 23% to HK$425 million. The AEL's market share fell to 23% from 25%.

Service promotion

Distribution channels were established and major marketing campaigns were launched to promote MTR overseas especially in China, and a partnering arrangement was entered into with Asia Miles to raise brand awareness among international travellers and create more cross-selling opportunities.

Fare promotions including the "Ride 10 Get 1 Free" offer and AEL's free tickets for children were launched to boost passenger volumes and overall fare revenues. These were supplemented by wider branding and loyalty programmes, including the relaunch of the MTR Club, new thematic campaign aimed at the youth market and the "Unsung Heroes" TV campaign.

Service performance

The Company maintained very high standards of reliability, safety, comfort and customer satisfaction during the year.

SARS-related initiatives, such as the distribution of face masks, increasing ventilation at stations and on trains, as well as additional cleaning of stations were successful in preventing any cases of transmission in the network. Contingency plans were also in place for events such as infection of employees.

Better performance of the Tseung Kwan O Line meant that overall performance levels improved dramatically, as measured by the service performance requirements under the Operating Agreement with the Government and our more stringent Customer Service Pledges. The reliability of automatic ticketing machines improved, and services were highly punctual. MTR passenger journeys on time were 99.9% and escalator reliability was 99.9%.

Maintaining quality services while being able to keep costs down contributed to high customer satisfaction levels recorded by our 2003 Service Quality Index for the MTR Lines and AEL with ratings of 69 and 81 respectively out of 100. We again scored well in the Community of Metros (CoMET) benchmarking report and won for the fifth time the Customer Service Award in the transportation category organised by "Next Magazine".

Service improvements

The largest network enhancement was the completion of four-tracking of the Airport Railway between Lai King and Olympic stations, as well as the new Nam Cheong Station on the Tung Chung Line (TCL). Four-tracking allows AEL and TCL trains to operate on separate tracks for 4.5 kilometres and its completion contributed to the successful opening of the interchanges with KCRC's West Rail at Nam Cheong and Mei Foo stations. During the year, TCL trains were converted from 7-car to 8-car formation, resulting in a 14% increase in capacity.

In 2003 we extended inter-modal fare discounts to travellers transferring to MTR from feeder buses on four New Lantau Bus routes in Tung Chung and nine Green Minibus routes in Tseung Kwan O, Kwun Tong and Causeway Bay.

The scheme to modernise stations resulted in new underground walkway and escalators in Mong Kok Station, a new entrance at Kowloon Tong Station, as well as improvements to Tsim Sha Tsui and Mei Foo stations.

Platform screen doors were installed at 36 platforms in 14 stations. During installation, we took great care to ensure not only timely completion but continued reliability of the train service.

We began service trials in May 2003 of optimising air circulation between the platform and tunnel at selected stations with retrofitted platform screen doors by re-setting the tunnel cooling supply temperatures, and the trials resulted in considerable energy cost savings.

Productivity increases

Productivity improved further from new designs, technologies and operational processes as well as the continuing hiring freeze and increased outsourcing.

Automatic train turnarounds at Tsuen Wan, Sheung Wan, North Point and Tiu Keng Leng stations has reduced turnaround times and manpower requirements. Work progressed on developing a fully automated operation and a group station control concept, which will allow the Penny's Bay Rail Link to operate more efficiently.

Full outsourcing of infrastructure maintenance of the Tseung Kwan O Line, including signalling, trackwork and power distribution, as well as trackside auxiliary equipment, was implemented, in line with the policy of partnering with contractors and outsourcing maintenance and operations activities where cost savings can be made without compromising quality or safety.

We continued to minimise the life-cycle-cost of our assets, including converting Urban Line trains for the Penny's Bay Rail Link, removing the need to buy new trains for that extension.

Other Businesses

Revenue from other businesses increased by 14% to HK$1,117 million despite the negative impact of SARS.

Advertising

Advertising in Hong Kong was severely affected by SARS with revenues falling by 3% to HK$386 million. Nonetheless, we continued to introduce new products such as trackside plasmas and revamp existing offerings, for example enlarging concourse and escalator crown panels. We also increased direct marketing to advertisers and advertising agencies. Internet acess centres with advertising sponsorship were opened in two stations.

Telecommunications

Competitive pricing by mobile telecommunications network operators and increasing mobile penetration accelerated growth in usage volumes in our network. This helped offset the negative impact from aggressive pricing and SARS, resulting in an increase in revenue of 6.5% to HK$198 million. During the year, the Company continued to develop in the mobile infrastructure and began installing the first public wireless LAN network so that wireless broadband internet access can be launched early in 2004 on the AEL. We are also upgrading the system to ensure seamless use of 3G services within the railway network.

Our wholly-owned subsidiary TraxComm Limited secured a fixed telephone network services license in June, enabling it to exploit business opportunities as Hong Kong's only service provider focused exclusively on the wholesale market. TraxComm began to operate its DWDM-based network alongside the fibre-optic network. Revenues from TraxComm in its first year were lower than expected but its long term contracts are a good base for expansion.

Station commercial facilities

Revenue from station commercial facilities was initially hurt by SARS, and the resulting slow-down or freezing of retailers' expansion plans. But the subsequent economic rebound combined with benefits from station renovations has more than offset the impact, leading to an increase in revenue of 16% to HK$275 million.

Renovation work in stations raised the total commercial floor area in the MTR network by 6% during 2003, and 25 new trades or brands were added.

External consulting

Our consulting business again posted strong growth as our reputation increased. Revenues rose 127% to HK$143 million as contracts were secured in the Netherlands, India and Mainland China.

In Mainland China MTR now maintains an office in Shanghai with over 100 employees in a joint venture company. This company was appointed as the owner's representative on the 31-kilometre Phase I of the Shanghai Rail Transit Line No. 9 in Shanghai, covering all aspects of project management.

Overseas investment

An agreement in-principle was signed with the Shenzhen Municipal Government for MTR to construct Phase 2 of Line 4 of the proposed Shenzhen Metro System and to operate the entire Line 4 for 30 years under a build-operate-transfer arrangement. The agreement also includes property development rights of 2.9 million square metres of commercial and residential property. The formal concession agreement is expected to be signed in 2004 following further design, planning and approval from the Beijing Central Government. In Beijing, we are evaluating an airport link and one other metro line opportunity. Elsewhere, light rail projects are under consideration for the Portsmouth area and Liverpool in the UK, and Vancouver, Canada.

Octopus Cards Limited (Octopus)

Octopus cards in circulation rose from 9.3 million in 2002 to 10.4 million at the end of 2003 and the number of service providers from 182 to 253. However profit contribution to the Company from Octopus Cards Limited decreased by 40.4% to HK$23.1 million due to the impact of SARS on travel and retail activities.

Together with MTR's consulting team, Octopus won contracts for a nationwide Automatic Fare Collection (AFC) system in the Netherlands, achieving its major target for 2003 of diversifying into international AFC consultancy. In Hong Kong, Octopus card usage increased in areas such as parking, retail and building access, whilst more financial service groups, led by Standard Chartered, Bank of China and AEON, joined the Automatic Add-Value Service.

Octopus won several awards, including a Brand Leader Award in Superbrands Hong Kong 2003 and Hong Kong Top Ten Brandnames Award 2003.

Property Review

In 2002 amid excess supply of flats in the market, we agreed with Government policy to stabilise the market and did not tender out any property development packages in 2003. As a result, none of the remaining tenders for packages in Tseung Kwan O Town Centre and Area 86 was awarded during 2003. Instead, we focused our efforts on preparing for possible resumption of tender activity in 2004, as well as completing and pre-selling developments under construction.

Mainly as a result of profit from sharing in kind from Two IFC, property development profit increased by 43% over 2002 to HK$5,369 million.

Airport Railway

On the Airport Railway, profit from sharing in kind of approximately HK$3 billion from the 18 floors of Two IFC and some 1,200 carparking spaces was booked in July. The 88-storey tower and IFC Mall were completed in July, while the two hotel towers are on schedule for completion in early 2005.

Given the project's complexity and tight construction time frame, its on-time completion was a major achievement and testified to the strong teamwork between all parties.

At Union Square in Kowloon Station, occupation permits were obtained for The Harbourside and Sorrento Phase 2. Foundation and basement excavation work for the 102-storey tower were completed and construction of the shopping centre, which will be majority owned by the Company, is on schedule.

At Olympic Station, refurbishment began at the Olympian City One shopping centre. At Tung Chung Station, 387 flats at Seaview Crescent Phase II and 1,240 flats at Caribbean Coast Phase II were launched for sale in June.

Tseung Kwan O Line and Choi Hung Station

Along the Tseung Kwan O Line, our joint venture developer Sino Land launched the pre-sale of Residence Oasis, a 2,130 unit-residential development above Hang Hau Station. We also began preparation of pre-lease marketing for the 3,500 square metre retail podium at Hang Hau Station which will be known as "The Link". On completion, this retail podium will become, together with the shopping centre at Union Square, our fifth and sixth shopping centres, adding to the strength and diversity of our investment portfolio.

At the Tiu Keng Leng Site A and Choi Hung Station developments, we are on target to begin pre-sales in 2004. At Tseung Kwan O Town Centre Area 55b, the New World led consortium modified the Government lease terms. This will increase flexibility in designing flat mix to better match market demand.

At Area 86, where the train depot is located, we revised and improved the conceptual plan to offer more breezeways and open space. The first tender is anticipated to be invited in late 2004.

Investment properties

The SARS outbreak and the weak economy had negatively impacted our investment properties but we took care to support our tenants, including offering temporary relief on rents. Revenue from investment properties declined by 1% to HK$888 million.

During SARS, performance of our staff was outstanding in ensuring shoppers' safety and maintaining public confidence in our shopping centres. We also designed tailor-made programmes for the growing number of high spending visitors from the Mainland, which helped boost business of our retailing tenants. The Total Quality Service Regime, our pioneering customer service enhancement programme, also helped raise the standard and reputation of our shopping centres.

The quality of Two IFC and its first class management services enabled the Company to attract tenants despite lingering cautious sentiment. Swiss banking giant UBS' decision to lease seven floors of the building was one of the most significant office relocations in Hong Kong in 2003. At year end, approximately 60% of MTR's 18 floors was leased.

Property management

Property management related business continued to expand and diversify during 2003, with revenue increasing by 11% to HK$94 million.

During the year, Coastal Skyline, Caribbean Coast, and Seaview Crescent Phase II at Tung Chung Station, and Sorrento Phase I at Union Square were added to our portfolio, increasing the total number of flats managed by 4,841 to 46,915. The most important single addition, however, was Two IFC, which is managed under Premier Management Service. As a result of Two IFC, total managed area of commercial and office space increased significantly to 558,796 square metres, from 370,022 square metres in 2002. Efficiency was enhanced by the new computerised web-based Job Management system that links with the existing Property Management System. Effective precautionary measures successfully restricted the spread of SARS in our managed estates, where we also promoted waste recycling.

Property agency

MTR Property Agency business remained profitable despite SARS and the weak market conditions. A total of 180 transactions was concluded, increasing revenue by 16.1% to HK$6 million.

China and overseas property business

We made further inroads in Mainland China. In 2003, we won a pre-management contract for the Tulip Gardens residential development in Shenzhen and for the Chongqing Palm Springs International residential development in Chongqing. In Beijing, we entered into a partnership with Beijing Century Sun Real Estate Development Company Limited to provide property management services and manage the Palm Springs International Apartments developments.

Future Projects

MTR made progress on new projects, working to schedule and budget whilst minimising impacts during construction. We also continued discussions with the Government regarding a partnership approach for future rail projects.

Penny's Bay Rail Link

Work on the Penny's Bay Rail Link connecting the new Hong Kong Disney Theme Park with the MTR network saw substantial progress, with all major civil and electrical and mechanical contracts either generally on or ahead of schedule, putting us on target for completion in mid-2005.

Tung Chung Cable Car

Following enactment of the Tung Chung Cable Car Ordinance in June the overall Project Agreement, together with Entrustment Agreements for related works at Ngong Ping, were signed with the Government in November. A Private Treaty Grant for the theme village adjacent to the Ngong Ping terminal was signed and environmental permits for the cable car and the stream diversion were granted at the same time, leading to the award of the building and civil engineering works contracts. Construction will begin in early 2004, with a target completion date of early 2006, and a total outlay of HK$950 million including capitalised interest.

Railway extensions

In January 2003, the Government requested MTR to proceed with planning for the West Island and the South Island lines, as extensions to the MTR urban network. Consultants and MTR staff began work on the feasibility study in mid-2003. Alternative proposals were considered and a project proposal will be submitted to the Government in the second quarter of 2004. The proposed alignment will provide a more cost-effective solution with better integration of the two new lines as well as improved interchanges with the existing network. The two lines will require direct Government funding support towards the capital cost. Design will commence as soon as Government support is secured. Construction is estimated to require approximately 48 months.

In November 2003, the Company was requested by the Government to submit a proposal for an extension of the Kwun Tong Line from Yau Ma Tei Station to Whampoa.

Pedestrianisation

During 2003, new pedestrian entrances were completed at Kowloon Tong Station and also Mong Kok Station, where a further integrated entrance is under construction as part of the Urban Renewal Authority redevelopment, due for completion in mid-2004.

Work began on a pedestrian link project at Admiralty Station, as well as on alterations to the southern concourse of Tsim Sha Tsui Station to link to the KCRC East Rail project, which is due for completion by the end of 2005.

Airport developments

The preliminary design was substantially completed for a new station at the end of the AEL at Chek Lap Kok airport to serve the proposed AsiaWorld-Expo development, which should be completed by the end of 2005, subject to concluding a satisfactory agreement.

Transit links

We undertook preliminary studies on a light rail solution for the Kowloon Bay Industrial Area and the West Kowloon Cultural District, as part of our intention to develop feeder services to the MTR mainline network from centres beyond the walk-in catchment.

Human Resources

During 2003, MTR was successful in further improving staff productivity whilst maintaining staff morale during SARS and preparing for the subsequent rebound.

Enhancing staff productivity

MTR is dedicated to continuously improving staff productivity. During the year we increased staff communication to improve understanding of the challenges facing MTR and maintain high levels of motivation. To better benchmark staff attitude, our Staff Attitude Survey launched at the end of 2003 was revamped to include an Employee Satisfaction Index.

Through our employees' efforts and commitment, our patronage and commercial activities recovered faster than originally anticipated. The Company therefore decided to compensate employees fully for the salaries forgone under the One Day No Pay Leave Per Month Programme launched in 2003 during SARS.

Talent development

Staff training is important to our continuous success and 47,688 man-days of training were conducted during the year. We received the international ASTD BEST Award from the American Society for Training and Development. Successful training was completed for Nam Cheong Station and we secured training consultancies for overseas metros including Shenzhen Metro, Bangkok Metro and Tianjin Binhai Metro.

Leadership development was strengthened by the New Horizon for Leaders programme for junior managers and senior supervisors, which in 2004 will be extended to junior supervisors. Putonghua and customer service training for frontline staff were implemented to help maximise revenue from the easing of restrictions on individual travellers from the Mainland.

Code of conduct

MTR advocates a high level of employee integrity. Our Code of Conduct will be updated to ensure continued compliance with new standards. As well, a new staff guidebook will be published to provide specific guidelines on employee behaviour.

Financial Review

Financing achievements

New financings

The Hong Kong dollar markets remained highly liquid. MTR privately placed HK$2.3 billion in Hong Kong dollar bonds and a US$100 million bond. Included in the Hong Kong dollar bonds was a HK$500 million 15-year issue which was the single largest 15-year fixed rate bond ever issued in Hong Kong. MTR also arranged Hong Kong dollar bilateral loan facilities totalling HK$5.2 billion. These transactions provided MTR with cost effective funding and helped extend its debt maturity profile. At year end, total undrawn committed bank loans amounted to HK$6.7 billion providing sufficient coverage for all our anticipated funding needs well into 2004. The coverage was further extended following a US$600 million 10-year Eurobond issued in January 2004. MTR also completed its first U.S. cross border leasing transaction using part of its fleet of trains, and net present value financial benefit received will be recognised as income over the terms of the lease.

Cost of borrowing

Accommodative U.S. monetary policy pushed short and long term interest rates to historical lows which combined with attractive terms of the new financings allowed MTR to reduce its overall borrowing cost further to 5.1% from 5.4%, reducing gross interest expense by HK$102 million.

Risk management

The Company continued to manage its financing activities according to its well-established Preferred Financing Model with the result that its debt portfolio remained well diversified by maturity, instrument, currency and interest rate risks, with good forward financing coverage.

Credit ratings

MTR maintained credit ratings on par with the Hong Kong SAR Government during 2003. Moody's affirmed the short-term foreign currency and long-term domestic currency ratings at P-1 and Aa3 respectively, and upgraded the long-term foreign currency rating by two notches to A1 with a stable outlook. S&P's ratings remained unchanged at A-1+/A-1 and AA-/A+ for short-term domestic/foreign currency and long-term domestic/foreign currency borrowings respectively with a stable/negative outlook on the foreign/domestic currency ratings. R&I also re-affirmed its short-term local currency and long-term domestic/foreign currency ratings at respectively a-1+ and AA/AA-.

Financing capacity

Total capital expenditures between 2004 and 2006, including maintenance of existing lines as well as construction of Penny's Bay Rail Link and the Tung Chung Cable Car, are estimated at HK$7.4 billion, giving MTR strong financing capacity to fund other new projects and investment opportunities, such as Shenzhen Line 4 and the South Island Line extension. The main expenditure for Shenzhen Line 4 is likely to be incurred after 2005, with the planned 40% equity investment to be financed by internal funds and external borrowings, and the remainder by non-recourse project financing in RMB.

Review of financial results

Profit and loss

Total patronage for the MTR Lines decreased by 0.9% from 777 million in 2002 to 770 million in 2003 owing to the effects of SARS. Average weekday patronage decreased to 2.24 million, compared to 2.26 million. Our overall market share of Hong Kong public transport increased from 23.5% to 24.3%, with cross-harbour share increasing from 58.2% to 58.7%.

Total fare revenue for the MTR Lines was slightly lower at HK$5,064 million. The average fare decreased from HK$6.65 to HK$6.57, as a result of promotions.

Airport Express Line average daily patronage declined by 19.4% to 18,700 due to the fall in visitor arrivals during SARS. Market share of airport passengers fell from 25% to 23%. Total AEL revenue dropped 23.1% to HK$425 million, the average fare decreasing from HK$65.43 to HK$62.07 due to promotions and fare concessions.

Non-fare revenues increased by 7.1% to HK$2,105 million, comprising HK$988 million from property rental and management and HK$1,117 million from station commercial and other revenue.

Operating expenses before depreciation increased by 4.8% to HK$3,847 million despite the full year's operation of the Tseung Kwan O Line. Staff costs increased from HK$1,579 million to HK$1,643 million for this reason and separation payments. A non-recurring deficit on property revaluation of HK$69 million was recorded.

Operating profit from railway and related operations before depreciation was HK$3,747 million, down 6.7% and representing a 49.3% margin compared with 52.2% in 2002. Excluding the non-recurring charge, the operating margin would have been 50.3%.

Profit on property developments was significantly higher at HK$5,369 million, mainly from Two IFC and the Sorrento development at Union Square.

Operating profit before depreciation increased by 17.3% to HK$9,116 million. Following a review of useful lives of assets, depreciation charges decreased by 2.8% to HK$2,402 million.

Net interest expense increased from HK$1,125 million to HK$1,539 million, reflecting the first full year's interest expenses on the Tseung Kwan O Line, but interest cover rose from 4.5 times to 5.6 times.

Revised accounting standard saw MTR recognise HK$748 million mostly in respect of deferred income tax.

Net profit for the year, including a contribution from Octopus Cards of HK$23 million, increased by 24.3% to HK$4,450 million and earnings per share were HK$0.85. A final dividend of 28 cents was recommended.

Balance sheet

Total fixed assets increased from HK$94,270 million in 2002 to HK$96,921 million as a result of the retained office space and car parks in Two IFC.

Railway construction in progress rose by 66.1% to HK$181 million, following reclassification of the Tung Chung Cable Car project cost from deferred expenditure.

Property development in progress amounted to HK$2,309 million, a reduction of 19.5% due to the transfer out of development costs in respect of Two IFC upon completion.

Debtors, deposits and payments in advance increased from HK$727 million to HK$1,153 million mainly due to proceeds receivable from sale of properties around year end.

Cash and cash equivalents stood at HK$376 million compared to HK$1,718 million.

Total loans outstanding amounted to HK$32,025 million, a decrease of HK$1,483 million, representing loan repayments.

Deferred income decreased from HK$6,226 million to HK$5,061 million, as amounts were recognised as profit from developments.

Share capital, share premium and capital reserve at HK$35,086 million, was slightly higher, as a result of shares issued from the scrip dividend and share options exercised.

Total shareholders' funds stood at HK$57,292 million, an increase of HK$3,718 million, mainly attributable to retained profits net of dividend payments, resulting in an improved gross debt-to-equity ratio of 55.9% against 62.5%, and net debt-to-equity ratio from 59.3% to 55.2%.

Cash flow

Net cash inflow from operations decreased slightly to HK$3,837 million due to lower operating profit from railway and related operations before depreciation. The major cash outflows related to payments for capital projects, interest, dividend, as well as a net loan repayment totalling HK$6,090 million, partly offset by property sale proceeds of HK$855 million. Overall, there was a net cash outflow of HK$1,320 million against a previous inflow of HK$1,518 million.

* Note: Comparisons refer to the 2002 financial year. Balance sheet figures refer to 31 December year end.