

CEO's review of operations and outlook

Dear Stakeholders,

I am pleased to report that MTR's operational results for the year 2004 experienced a dramatic rebound over 2003, a year when our operations were severely impacted by the weak economy, soft property prices and, most significantly, the outbreak of SARS.

The strong operational results achieved in 2004 were brought about by a broad based economic recovery in Hong Kong which also led to a significant increase in property prices. The Company has managed this recovery well. Growth in patronage led to significant fare revenue increases. Growth in non-fare revenues was even stronger, propelled by buoyant station businesses and improved rental rates for our investment properties.

Property development profit also exceeded our earlier expectation, although it was lower than the very high property development profit recognised in 2003 on receipt of our 18 floors in Two IFC.

The Company's favourable performance produced good financial results in 2004. MTR recorded total revenues of HK\$8,351 million, an increase of 10.0% over the previous year while operating profit before property development, interest and depreciation improved by 21.3% to HK\$4,546 million. With property development profit of HK\$4,568 million recognised for the year, a reduction of HK\$801 million from 2003, net profit improved marginally by 1.0% to HK\$4,496 million. However, earnings per share decreased slightly by 1.2% to HK\$0.84 as more shares were issued during the year. The Board recommended a final dividend of HK\$0.28 which together with the interim dividend of HK\$0.14 brought the full year dividend to HK\$0.42, the same as last year.

Review of operations

After a sharp rebound in patronage from SARS in the second half of 2003 passenger growth continued through 2004, assisted by the economic recovery in Hong Kong, an increase in tourist arrivals from the Mainland, and the opening of our West Rail interchanges in December 2003. Total patronage for the MTR Lines increased significantly by 8.2% to 834 million. Airport Express (AEL) also saw a strong recovery, with total patronage rising 17% to reach 8.0 million, following an increase in air passenger traffic at the Hong Kong International Airport.



Our market share also improved with our overall share of total franchised public transport rising to 24.8% from 24.3% in 2003, while our cross-harbour market share increased to 59.6% from 58.7%. The Company's estimated market share of passengers travelling to and from the airport decreased from 23% to 21%, partly due to a change in the mix of visitors arriving at and departing from Hong Kong's airport.

The increases in patronage and market share were supported by the continuing high quality of service. In 2004, our customer service performance continued to surpass both the Government's requirement under the Operating Agreement and our own more stringent Customer Service Pledges. In fact, during the year, statistics measuring MTR performance were among the best on record at MTR. The number of journeys experiencing a delay of five minutes or more showed a 25% improvement over 2003. MTR passenger journeys on time were 99.9%, supported by 99.9% reliability for train service delivery, which were amongst the best in the world. In January, MTR employees won extensive praise for their rapid and effective response to an arson attack on an Urban Line train, by resolving the incident quickly, thus preventing injury to our passengers and employees, and allowing us to resume normal service swiftly.

Regrettably, a number of noticeable incidents in the latter part of the year had given rise to public concerns over the reliability of our system. Based on the principle of continuous improvement and

to address passenger concerns, the Company set up a high-level internal task force to seek operational improvements. We also commissioned an independent study by Lloyd's Register Rail, a leading international rail expert and validation agency, to conduct a comprehensive review of our assets and asset management practices.

Following the conclusion of the internal task force investigation in November, we have begun implementation of a series of improvement initiatives to augment our maintenance regime and incident handling procedures. The Lloyd's Register Rail report was received in early February 2005. The report's recommendations are constructive and useful. We will study the report in detail and set up the necessary organisations and processes to implement the recommendations expeditiously whilst at the same time taking immediate action to address some of its recommendations. We are encouraged to note that the report did not find any evidence to suggest MTR assets are declining as the system enters its 25th year of operation and our asset management system is recognised to be in line with international best practice. Nevertheless, both the Board and management are committed to ensuring that the Lloyd's Register Rail recommendations are effectively implemented to ensure that the people of Hong Kong continue to enjoy a safe, reliable and efficient mass transit service that they can be proud of.

MTR continued to seek improvements in efficiency and productivity through

various initiatives. As a result, our railway operating costs per car km during the year fell by 1.8% to HK\$22.1.

Our station commercial and other revenues benefited significantly from the economic recovery and strong rebound in consumer spending, growing by 17.4% to HK\$1,311 million. The substantial increases in advertising and telecommunication income were particularly noteworthy. Our strategy to upgrade advertising facilities and introduce new formats, such as the trackside plasma TV network introduced during the year, has proved most effective and boosted advertising revenues by 21%. The station renovation programme to add more space, vibrancy and a better trade mix to MTR stations also helped improve station commercial revenues.

In telecommunications, MTR became one of the first rail networks in the world to be 3G enabled as we successfully upgraded our existing integrated radio system on the Island Line to support UMTS based 3G service. Our fixed-line subsidiary TraxComm began operation and management of a 50 Gigabit bandwidth network, serving a number of telecommunication service operators in Hong Kong.

With the economic recovery, further increases in the number of service providers and a rise in average daily usage of the Octopus card, pre-tax profit contribution from Octopus Cards Limited increased significantly by 91.3% over 2003 to HK\$44 million.

MTR has for some time been active overseas in external consultancy and this work currently extends to contracts in 22 cities in 11 countries. During 2004 we made the strategic decision to reorient this business to refocus on service contracts which are larger and of longer duration, and which are likely to lead to investment opportunities. This refocus has already led to an improvement in consultancy profitability.

On future Hong Kong projects, we made significant progress on the construction of Disneyland Resort Line (DRL), formerly known as the Penny's Bay Rail Link, which will connect Hong Kong Disneyland with the Tung Chung Line, and are confident of meeting the target completion date of 1 July 2005. The Tung Chung Cable Car project, our major new tourist attraction project for Hong Kong, is also on track for completion by early 2006, following the start of construction work in February 2004.

In February, we put forward our proposal to the Government to extend the Kwun Tong Line from Yau Ma Tei Station to the popular residential area of Whampoa Garden. In March, following extensive consultations and much hard work, the Company submitted revised proposals on WIL and SIL to the Government. All of these proposals are currently under review by the Government.

With a buoyant property market in 2004, MTR achieved highly satisfactory results in our property businesses, as more developments were completed and sold. Together with our property developers, we launched and achieved very strong sales in developments at The Harbourside, Carmel Cove of Caribbean Coast and 8 Clearwater Bay Road, as well as achieving good results from developments previously launched for sale such as Coastal Skyline, Monterey Cove and

Albany Cove of Caribbean Coast, and Residence Oasis. We and our property developers sold or pre-sold 3,554 units in 2004. As a result, profit from property development was HK\$4,568 million.

The main contributions to property development profit came from sharing in kind in respect of the Union Square retail shell structure at Kowloon Station, recognition of deferred income relating to the Caribbean Coast and Coastal Skyline developments at Tung Chung Station and The Harbourside at Kowloon Station, and share of surplus proceeds from Residence Oasis at Hang Hau Station in Tseung Kwan O and The Harbourside at Kowloon Station. However, this high level of property development profit was, as forecasted, lower than that achieved in 2003 which was favourably impacted by the receipt of 18 floors in Two IFC.

In Tseung Kwan O, following approval in August 2004 for a substantial improvement to the Master Layout Plan for the "Dream City" at Area 86, developers were invited to tender for Package One of Area 86 in December. The package was ultimately awarded to City Investments Limited, a subsidiary of Cheung Kong (Holdings) Limited, in January 2005. This was our first development tender since October 2002. The tender invitation differed from our previous format as we offered to pay half of the land premium in return for a higher profit sharing ratio. This method allows us to increase our profit participation in the development, albeit at slightly increased risk, whilst attracting a number of large and medium sized developers to the tender. Elsewhere in Tseung Kwan O, the Occupation Permit was issued for the 2,130-unit Residence Oasis at Hang Hau Station in December, allowing us to record profit from this development earlier than we had originally anticipated.

Property rental and management income increased by 12.1% to HK\$1,108 million. This was mainly the result of higher rental income from Two IFC, arising from a faster than expected commitment by tenants at higher rents, together with strong performance in all four shopping centres and an expanded portfolio of managed properties.

Another notable achievement by the Company during the year was the launch of our revised Vision, Mission and Core Values. These statements of strategic intent and values will now guide us into the future as the Company continues to grow our business in Hong Kong and beyond.

Financial performance

The financial results for 2004 reflected an all round improvement in every aspect of our businesses. Total fare revenue for the MTR Lines amounted to HK\$5,417 million, a 7.0% increase over 2003, while that from AEL increased by 21.2% to HK\$515 million. Taking into account non-fare revenue including property rental and management income which in total rose 14.9% to HK\$2,419 million, total revenue grew by 10.0% to HK\$8,351 million.

Despite a general increase in business activities during 2004, operating expenses were well contained with gains in productivity. This, together with the write-back of a prior year revaluation deficit for our self-occupied office property, led to operating expenses before depreciation reducing by 1.1% to HK\$3,805 million. Consequently, operating margin for the year improved significantly to 54.4% compared with 49.3% in 2003. Profit from property development was HK\$4,568 million, a reduction of HK\$801 million from the very significant property development profit recorded in 2003 when MTR

received our 18 floors in Two IFC. Depreciation charges increased by 4.6% to HK\$2,512 million from HK\$2,402 million in 2003, mainly due to a full year's depreciation on the West Rail Interchange and on new railway assets. Net interest expenses decreased by 5.8% to HK\$1,450 million mainly as a result of lower borrowing costs. The Company's share of Octopus Cards Limited's pre-tax earnings was HK\$44 million for the year. After deducting income tax expenses of HK\$700 million, the Group's profit attributable to shareholders for the year was HK\$4,496 million, a slight increase of 1.0% over 2003.

In January, the Group took advantage of the favourable market and successfully launched a 10-year US\$600 million fixed rate bond. The transaction not only enabled us to obtain cost-effective fixed-rate long-term funds and to extend our debt maturity profile further, but also established a new 10-year US dollar benchmark for Hong Kong's quasi-sovereign credits. As a result of the attractive terms of our new financings and low interest rates prevailing during the year, we were able to reduce our average borrowing cost further to 4.7% from 5.1% in 2003.

Growth beyond Hong Kong

In the annual report last year, I discussed our strategy of seeking growth outside Hong Kong. While Hong Kong will firmly remain our home market, we shall use our core capability as a world class rail operator and property developer to capture business opportunities outside Hong Kong with the objective of creating value for our shareholders and development opportunities for our staff.

Whilst we see tremendous growth opportunities overseas, particularly in the Mainland China and Europe, we are

mindful of the associated business and financial risks, as well as our responsibility to create value for our shareholders. As such, when evaluating and deciding on these investment opportunities we will be guided by prudent commercial principles that aim to deliver an appropriate risk-adjusted return.

In Mainland China, our investment strategy is focused on the major cities where the demand for mass rapid transit systems and hence potential for profit is the greatest due to expanding populations, heightened environmental concerns and increasing traffic congestion. We shall also adopt various business models to meet the different market needs. In some cases, we can repeat the very successful "rail and property model" as used in Hong Kong, whilst in other cities we may choose a PPP model where Government funds most of the capital expenditure.

As reported last year, in January 2004 we signed an Agreement in Principle with the Shenzhen Municipal People's Government to build, operate and transfer Phase 2 of Line 4 of the Shenzhen Metro System, and to operate the entire line for 30 years when Phase 2 is completed. The total investment in this project is approximately RMB 6 billion (HK\$5.7 billion). The project will be implemented based on the "rail and property model", with associated property developments of 2.9 million square metres of commercial and residential space along the railway.

Since signing the Agreement in Principle, we have begun preliminary project design and construction works as well as negotiations with the Shenzhen Municipal People's Government on a Concession Agreement and other related agreements which would give MTR,

through our project company, the right to construct Phase 2 and to operate the entire Line 4. However, given the current economic climate in China, it is possible that the necessary government approvals, including that from the Central Government, may take longer than originally anticipated.

In December we signed a separate Agreement in Principle to form a PPP with Beijing Infrastructure Investment Co. Ltd. (BIIC) and Beijing Capital Group (BCG), both subsidiaries of the Beijing Municipal People's Government, for the investment, construction and operation of the Beijing Metro Line 4 for a period of 30 years. The total investment for this project is estimated at RMB 15.3 billion (HK\$14.4 billion). Based on the PPP framework, the Beijing Municipal People's Government will fund 70% of the total project cost, comprising mainly land acquisition and civil construction, with the remaining 30% funded by the PPP company. This 30% will mainly consist of provision of trains and related electrical and mechanical systems, costing approximately RMB 5 billion (HK\$4.7 billion), over 60% of which would be financed by non-recourse RMB debt. The balance will be funded by equity contribution from the PPP partners, of which MTR will own 49%, with BIIC and BCG owning respectively 2% and 49%. Hence our equity contribution to this project is estimated to be RMB 735 million (HK\$693 million). In February 2005, this project took another step forward when MTR and its partners together with the Beijing Municipal People's Government initialled the 30-year Concession Agreement, which will become effective when approval from the National Development and Reform Commission is obtained.

In addition to these two major investment opportunities, the Company is in active discussions with parties concerning other projects in Beijing, Shenzhen and Shanghai.

In contrast to Mainland China, our expansion strategy in Europe can be characterised as "asset light". We will seek to enter into joint-venture partnership with experienced local firms to bid for operation and maintenance franchises and contracts, as deregulation of railway industries in Europe continues to unfold. Our initial focus will be on the highly deregulated UK market.

In November, the Company signed a joint-venture agreement with the UK's Great North Eastern Railway Holdings Limited to jointly bid for the Integrated Kent Franchise in southeast England. Since December we have been working to pursue a similar opportunity in Thameslink / Great Northern Franchise, which serves London north and south of the River Thames. Although we believe that our two consortia have competitive advantages in their respective bids, as with all tenders there is no certainty that either consortium will be successful.

Possible merger between MTR and KCRC

During the year, we worked hard in close co-operation with KCRC on the merger discussions. As a result, we were able to complete and present our joint merger proposal to the Government in September. This joint proposal, which we believe properly addresses the five parameters set out by the Government when it invited the two corporations to begin discussions, is currently under review by the Government. At the same

time, the Company has started discussion with the Government on terms of the possible merger. Our stance on the merger has always been that if properly structured and on acceptable terms, it benefits all our stakeholders.

People

MTR's performance is the achievement of our people. It is their dedication and professionalism that took us through the difficult year of 2003 and the challenges in the eventful but rewarding 2004.

During the year, we continued to work hand in hand with our people, creating opportunities for their development and growth, including tailor-made training programmes. Open and clear communications with employees was of paramount importance in 2004, as we sought to align the new Vision, Mission and Core Values with all of our people in a series of workshops and continued to keep them abreast of developments surrounding the possible merger.

We again received considerable recognition for our achievements in our people development process. The Operations Training Department gained Integrated Management System – ISO9001, ISO14001 and OHSAS18001 accreditation. The Company also secured a "Most Innovative Award" from the HKMA's Excellence in Training programme and a "BEST" Award from the American Society for Training and Development. Most significantly, for the third consecutive time, we were recognised by the Hong Kong Labour Department with a Good People Management Award, making us the only company to have achieved this.

Outlook

Although the ongoing macroeconomic adjustments in Mainland China, the recent sharp increases in oil prices and the US Federal Reserve's decision to tighten monetary policy have all aroused concerns, on balance we are cautiously optimistic about Hong Kong's business outlook in 2005. We expect economic conditions in Hong Kong to continue to improve albeit at a slower rate of growth than in 2004.

Our rail business should be positively impacted by the opening of the new lines, including the Disneyland Resort Line and KCRC's Ma On Shan Rail, but this will be partially offset by the opening of KCRC's Tsim Sha Tsui Extension in October 2004. Our station commercial and related businesses should continue to benefit from improved economic activities in Hong Kong.

Our property rental and management business will benefit from Two IFC being fully leased. In our property development business we expect that over the next two years, the bulk of such profit will come from the remaining Airport Railway developments as they are completed. Beyond that, we expect our Tseung Kwan O property developments to be a significant contributor. In our Airport Railway developments we expect to receive our share of the remaining 25,245 gross square metres of retail shell structure at Union Square mainly over the next two years, and the fit out works will take three years prior to an anticipated opening date of end 2007.

In January 2005 we received the remaining up-front payment of HK\$936 million relating to Olympic Package Three. This will be booked to our profit and loss account in accordance with the progress of construction and pre-sale activities, expected to be over the next two years. At Tseung Kwan O, profit from the successful Residence Oasis at Hang Hau Station was already recognised in 2004. In 2005, we will receive the 3,500 gross square metres shopping arcade, "The Lane" in Hang Hau Station. Booking of profit for the other three Tseung Kwan O residential developments currently being built, at Tiu Keng Leng, and Tseung Kwan O Town Centre Area 57a and Area 55b, will depend on the timing and progress of pre-sales as well as the timing of receipt of the Occupation Permit. Currently we expect only the development of 390 units at Tseung Kwan O Town Centre Area 57a to receive Occupation Permit in 2005. Package One of Area 86, which was awarded in January 2005 is not expected to contribute to our financial results before 2008. Given current property market conditions and planned development and pre-sale activities, the relatively fewer projects from which we anticipate to record profit in 2005 could lead to lower property development profit recognition than that recorded in 2004.

The Company's financial statements and results may be affected by a number of accounting changes in 2005, notably those relating to valuation of investment properties and financial instruments, which came into effect on 1 January 2005. I will refer you to the more detailed discussion of these in the Financial Review section.

Finally, I would like to extend my gratitude to my fellow Directors, management and all employees, as well as customers, suppliers and shareholders, for their contributions to MTR's continuing success during the year.



C K Chow, *Chief Executive Officer*
Hong Kong, 1 March 2005