

# CEO's review of operations and outlook



MTR Corporation seeks profitable growth outside of Hong Kong by pursuing metro investment opportunities in the Mainland of China and 'asset light' railway operating franchises in Europe.

Dear Stakeholders,

The strategy of MTR Corporation is to create value by seeking growth both in Hong Kong and overseas. I am pleased to report that MTR Corporation achieved strong financial results in 2005 with contributions from all our businesses. We were also encouraged to see that our international expansion strategy has begun to take root and achieved a number of important milestones. For the year, MTR Corporation generated revenue of HK\$9,153 million, 9.6% higher than the previous year, while net profit attributable to equity shareholders, excluding revaluation of investment properties, rose 36.7% to HK\$6,140 million. As I noted in last year's annual report, a number of new accounting standards were introduced in Hong Kong effective 1 January 2005. One of these new standards requires the revaluation of our investment properties to be recognised as a profit or loss in the year. In 2005, investment property revaluation yielded a profit of HK\$2,800 million pre-tax (HK\$2,310 million post tax). Including investment property revaluation, net profit attributable to equity shareholders of MTR Corporation has therefore increased by 29.1% to HK\$8,450 million with earnings per share increasing 26.0% to HK\$1.55. The Board has recommended a final dividend of HK\$0.28 which when combined with the interim dividend of HK\$0.14 brings the full year dividend to HK\$0.42, which is the same as last year.

## Operational review

In Hong Kong, MTR Corporation benefited from a buoyant economy and an active property market.

### Hong Kong railway operations

It is MTR Corporation's mission to provide world class rail services to the people of Hong Kong. The year 2005 drew to a close with record patronage for MTR. On 23 December 2005, 2.81 million passengers rode on MTR, the highest number of passenger trips the Company has ever recorded on a single, regular 19-hour service day since we began operations 26 years ago.

For the year as a whole, total patronage on the MTR Lines reached a record high of 858 million, an increase of 2.9% over 2004. It is pleasing to see that, under intense competition, MTR Corporation's

share of the total franchised public transport market has increased to 25.2% from 24.8% in 2004, and our cross-harbour market share to 61.2% from 59.6% in 2004.

Patronage on AEL also increased by 6.0% to 8.5 million due to higher numbers of air passenger arrivals and departures at the Hong Kong International Airport, boosting the average daily patronage to 23,300.

For the sixth year in a row, our customer service performance surpassed both the Government's minimum requirement under the Operating Agreement, and our own more stringent Customer Service Pledges. During the year, train service delivery was 99.9%, making MTR one of the most reliable rail systems in the world. In line with our continuous improvement culture, MTR Corporation has taken on board all the recommendations to enhance asset management contained in the Lloyd's Register Rail Report issued in February 2005, with 12 out of the 16 recommendations completed within the year.

Our network expanded in 2005 with the opening of DRL in August. It connects Hong Kong Disneyland with the MTR network via the interchange station at Sunny Bay on the Tung Chung Line. With its creative design, this theme train quickly became a favourite of Disneyland visitors. In December the AsiaWorld-Expo Station on AEL was opened, providing direct service to and from Hong Kong's newest and largest exhibition facility. The programme to retrofit platform screen doors in MTR underground stations was substantially completed at the end of 2005, providing a better station environment for our passengers. Final completion of the programme is expected in the first quarter of 2006.

The Company was again recognised for providing high quality service by a number of external organisations. Locally, these included the Public Transport Category award in *East Week Magazine's* first ever "Quality Living Award HK 2005", and for the seventh year in a row, the "Top Service Award 2005" – Public Transport Category from *Next Magazine*. We won our first major award in China – the "2005 China National Quality Management Award" from the China Association for Quality. MTR Corporation was also named runner-up in the global "Robert W. Campbell Award" for demonstrating leadership and excellence in integrating safety, health and the environment into operations. On a lighter note, one of the Company's 25th Anniversary TV Commercial "MTR – Metro News Version" received the "Most Delightful TV Commercial" award at the 11th Annual Most Popular TV Commercial Award Presentation organised by ATV in Hong Kong.

I would like to pay tribute to those colleagues who kept Hong Kong moving in the week of the World Trade Organisation Hong Kong Ministerial Conference in December 2005. Through their meticulous planning and implementation, MTR Corporation was able to provide continuous service for the people of Hong Kong during that turbulent week.

### Station commercial and other businesses

Accelerating the growth of non-fare revenue is an important part of MTR Corporation's strategy. Our station commercial and other businesses registered 18.6% revenue growth to HK\$1,555 million during the year on the back of a strong economy, improved consumer spending and higher consultancy revenue.

In advertising, we continued to enhance the attraction of our advertising venues through format refinement and innovation. During the year, audio advertising, platform bunting in stations, lit-up billboards above station entrances and enlarged advertising cards in trains running on the MTR Lines were introduced in our system. MTR Corporation is the leader in the outdoor advertising market in Hong Kong. In 2005, revenue from advertisement grew by 9.2% to HK\$510 million. In telecommunications, our entire network was upgraded to achieve full 3G coverage in October. Station retail rental income benefited from a combination of increased patronage, strong consumer spending, higher rentals and expanded retail floor space brought about by the renovation of stations. In 2005, we completed renovation of the retail zones at 20 stations, which allowing for the repossession of retail area of 1,690 square metres in Kowloon Station to facilitate integration works with Union Square, added 353 net square metres of commercial space and a total of 99 new shops. Revenue from station retail rental grew by 15.4% to HK\$344 million.

In our external consultancy business, our strategy is to develop opportunities for our overseas investment business utilising core capabilities of the Company. In 2005, this business continued to grow, with revenue reaching HK\$211 million. In the Mainland of China, several new consulting and training contracts were signed in cities including Beijing, Changchun, Shanghai, Tianjin, Guangzhou and Zhuzhou for local as well as multinational organisations. The project consultancy work for Line 9 of Shanghai Rail Transit is progressing well. In Hong Kong, we secured a renewal of the maintenance contract for the Automated People Mover system at the Hong Kong International Airport, and have begun work on the extension of the system to SkyPlaza and the SkyPier. Overseas, more than 30 new projects were secured. Major milestones were reached on existing work in Macau, Taiwan, the UK and the Netherlands.

### New Hong Kong projects

With DRL and AsiaWorld-Expo Station successfully completed, our focus has turned to "Ngong Ping 360", which will be a world class tourist attraction in Hong Kong. It comprises a cable car ride starting from Tung Chung and passing over some of the most beautiful natural scenery in Lantau Island to a cultural theme village in Ngong Ping. Substantial progress was made during 2005 on this project, including work on the superstructures at the two terminals and two angle stations, installation of the electrical and mechanical equipment, as well as completion of all sections of rope pulling. Based on progress to date, "Ngong Ping 360" is expected to open in mid 2006.

Public support remains extremely strong for the construction of WIL which will extend the current MTR Island Line service to the Western District of Hong Kong Island. After the Government's decision in June to request the Company to proceed with further planning and preparation of this extension, we have begun preliminary design work and are in active discussions with the Government on detailed scope, cost and implementation, as well as funding. We shall work hard to commence the construction process as soon as final approvals from the Government are obtained in order to provide an efficient and high quality mass transit service for the 200,000 people living and working in the Western District.

Also under discussion with the Government is the South Island Line (East), which will provide much improved transport services between Central and the Southern part of Hong Kong Island and facilitate the rapid development of tourism and commercial activities in the Southern District. We shall work with the Government to develop this concept further as part of the overall planning review of tourism and commercial development in the Southern District of Hong Kong Island and the Ocean Park Re-development.

### Property businesses

Our property businesses benefited from a strong economy and positive sentiment in the property market, albeit successive increase in interest rates had a moderating effect on the market towards the latter part of the year.

Taking advantage of favourable market conditions, we launched sales and pre-sales programmes for a number of residential developments along the Airport Railway and the Tseung Kwan O Line during the year. They included, along the Airport Railway, Harbour Green at Olympic Station, Carmel Cove at Caribbean Coast, Le Bleu at Coastal Skyline and The Arch at Kowloon Station and on the Tseung Kwan O Line, The Grandiose (Area 55b), Central Heights (Area 57a) and Phase I of Metro Town (Tiu Keng Leng Station). All of them met with strong responses.

Following the successful tender of Tseung Kwan O Area 86 Package One in January, invitation for the tender of Tseung Kwan O Package Two took place in December and the development right was awarded to Rich Asia Investments Limited, a subsidiary of Cheung Kong (Holdings) Limited, in January 2006. After evaluating market conditions and balancing reward and risk, in 2005 we decided to pay half of the land premium in return for a larger share of development profit for Package One, and in 2006 to extend a HK\$4.0 billion interest free loan to the developer in return for an increased sharing in kind of the Package Two development.

Property development profit in 2005 was HK\$6,145 million. It was recognised mainly from projects along the Airport Railway, which comprised profit sharing from The Arch, deferred income recognition and sharing in kind, mainly from the receipt of an additional retail shell area of 16,560 square metres gross at Elements

in Union Square. From Tseung Kwan O Line developments, profit was primarily recognised from sharing in kind from The Lane and further proceeds from Residence Oasis, both at Hang Hau Station, and sale of the small retail podium at Central Heights (Area 57a).

In our investment property business, rental income increased by 19.0% to HK\$1,183 million. Occupancy levels at all our shopping centres were maintained at 100%. The Lane, which opened in April, added 3,500 square metres gross of retail space and was fully let from the first day of operation. Rental income was also boosted by the increased share of income from Telford Plaza II, as a result of the commercial agreement with the other co-owner beginning in January 2005.

International marketing and pre-letting of Elements, our new flagship mall at Union Square, has met with a positive response, and pre-letting of The Edge, a new shopping centre at Tseung Kwan O Station, also saw good progress. Our 18 office floors at Two International Finance Centre remained fully let in 2005. In Beijing, we signed a long-term head lease with a Beijing developer for the operation and property management of Oriental Kenzo, a shopping centre of 31,000 gross square metres in the city's Dong Cheng district, with target re-opening in late 2006 after refurbishment.

The property management business saw steady growth in revenue during the year, with units added from Caribbean Coast, Le Bleu and Residence Oasis. As at the end of 2005, the number of residential units under MTR Corporation's management in Hong Kong rose to 54,358 flats, while commercial and office space increased to 562,296 square metres.

### Overseas growth

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### Mainland of China

In the Mainland of China, a number of significant milestones were achieved in 2005.

In 2004, we had signed an Agreement in Principle with the Shenzhen Municipal Government to build Phase 2 of the Shenzhen Metro Line 4 and to operate both Phase 1 and Phase 2 of the line for 30 years. As part of the agreement, the Company will be granted development rights for 2.9 million square metres gross floor area. This replicates the "rail and property" business model which has been successfully employed by the Company for the development of the Hong Kong metro network. In May 2005, the Concession Agreement for this RMB6 billion project was initialled between the Company and the Shenzhen Municipal Government, and a feasibility study report was submitted for Central Government approval to NDRC. This was followed by detailed design and site preparation work, and subsequently in November by ground breaking for a trial section of Phase 2. An MOU was signed with the Shenzhen Municipal

Government in May, which covers co-operation on Shenzhen Metro Line 3, and discussions continue.

We also made good progress on our first investment project in Beijing. In February, the PPP company 49% owned by the Company, 2% by Beijing Infrastructure Investment Co. Ltd. and 49% by Beijing Capital Group, initialled the Concession Agreement for investment, construction and operation of Beijing Metro Line 4 for 30 years with the Beijing Municipal Government. With a total investment of RMB15.3 billion, the project involves investment of around RMB4.6 billion by the PPP company to finance the provision of trains and related mechanical and electrical systems, and the balance by the Beijing Municipal Government for land acquisition and civil construction. In September, NDRC granted approval for the project and in December, the Joint Venture Agreement and Company Articles of Association were approved by Ministry of Commerce, followed by issuance of a business license by the State Administration of Industries and Commerce in January 2006, thus completing all required registrations for the PPP company. Preparation work, including drawing up tenders for the provision of trains and electrical and mechanical systems, is now well underway. Beijing Metro Line 4 is expected to commence operation in the second half of 2009.

We have initialled the term sheet or loan agreements relating to the non-recourse bank financings for the Shenzhen and Beijing projects. These are denominated in RMB and provide a substantial portion of fixed rate funding and a long maturity period, which will reduce the financial risk.

A number of other cities in China have plans to construct metro systems under the policy of using rail as the backbone of metropolitan transport. MTR Corporation is well positioned to take advantage of this very considerable business opportunity. In May, we signed an MOU with Wuhan Urban Construction Investment and Development Group Co. Ltd. and Wuhan Municipal Development Planning Commission of the Wuhan Municipal Government, which covers co-operation opportunities for the construction and operation of the Wuhan metro network.

## Europe

During 2005, we participated in the bidding for three train operating franchises, two in the UK in conjunction with local partners, and one in Scandinavia. Although we did not succeed in these bids, we have gained valuable experience from the process which will allow us to be a stronger contender for future opportunities. For 2006, we have identified and are likely to work on a number of possibilities in the UK and Scandinavia. These include the South Western Trains Franchise for which the Company has been pre-qualified for bidding, and the North London Railway Franchise (formerly Silverlink Metro Franchise), both in the UK.

## Financial review

As noted in last year's Annual Report, our financial results in 2005 were impacted by a number of accounting changes, particularly that relating to investment property revaluation. In our operations, we achieved strong financial results in all areas of businesses. Fare revenue for the MTR Lines rose by 5.6% from 2004 to HK\$5,721 million whilst that for AEL increased 8.9% to HK\$561 million. Non-fare revenue, including advertising, telecommunications, station commercial business, property rental and management income as well as income from consultancy business, jumped 18.7% to HK\$2,871 million. As a result, total revenue for the year reached HK\$9,153 million, an increase of 9.6% from 2004.

Despite the increased scale of business, the opening of DRL and the AsiaWorld-Expo Station and growth costs related to our overseas expansion, we were successful in containing cost increases to a level below revenue growth. Operating costs excluding depreciation for the year amounted to HK\$4,052 million, 6.0% higher than last year. This helped boost operating profit before depreciation for the year to HK\$5,101 million, a 12.6% increase from 2004 with operating margin before depreciation improving to 55.7% from 54.2% in 2004.

Benefiting from the improved property market sentiment in the year, profit from property development was HK\$6,145 million, an increase of 34.5% from 2004. Depreciation charges increased by 7.3% to HK\$2,682 million mainly due to completion of DRL, further platform screen door retrofitting, station renovation projects and the change in an accounting policy on rails. Net interest expenses decreased by 6.1% to HK\$1,361 million mainly as a result of strong cashflow and reduced borrowings. Excluding investment property revaluation, MTR Corporation's profit after tax from underlying businesses was HK\$6,140 million or HK\$1.13 per share, increases of 36.7% and 34.5% respectively from last year. After accounting for revaluation of investment properties, reported earnings attributable to equity shareholders of MTR Corporation for 2005 were HK\$8,450 million with earnings per share of HK\$1.55, representing increases of 29.1% and 26.0% respectively over the reported earnings of last year as restated for the accounting changes.

MTR Corporation's cash flow was strong in the year with net inflows of HK\$5,189 million from our recurring businesses and HK\$2,610 million from property development. After payments for capital expenditure and interest, MTR Corporation recorded positive cash flow before dividends and loan repayment of HK\$2,823 million. Dividend payments in 2005 were HK\$1,138 million and the majority of the remaining net cash flow of HK\$1,685 million was used to repay debt.

## Merger discussions

In September 2004, MTR Corporation and KCRC presented a joint merger proposal to the Government which we believe adequately addresses the parameters as set out by the Government. During the year we continued discussions with the Government on the terms of the possible merger, and the proposal is still under review by the Government.

## People

The success of our business heavily depends on skilled and dedicated people and we have continued to invest heavily in their training and development. An individualised and focused approach to leadership development was introduced to enhance the effectiveness of our managers. We launched three new core programmes to develop the consulting and business skills of our dedicated resource pool to support the Company's growth business. We also introduced a series of skill enhancement programmes for managers and supervisors focusing on effective communication and management skills.

In line with our core values to foster a culture of "Enterprising Spirit", an innovative scheme, the Enterprising Pod, was launched in 2005 to encourage staff to generate and contribute their original ideas that lead to business growth. A senior manager will perform the role of an "Idea Guardian Angel" to nurture each idea so that it can be tried and tested in real life operation. The scheme had received numerous submissions from staff at different levels.

I take great pride in the ability and performance of the 6,513 staff of MTR Corporation. They are amongst the most capable and dedicated in Hong Kong and I thank them for providing Hong Kong with one of the world's best mass transit systems. The Company is committed to providing staff with a safe and attractive working environment, as well as training and development opportunities to help them fulfil their ambitions. In 2005, MTR Corporation provided a total of 36,689 man-days of training to our workforce. In addition, a series of work / life balance seminars were held to raise staff awareness of the concept of "healthy mind, healthy body", a lifestyle that would not only enhance the well-being of our staff, but contribute to an even higher level of performance.

## Outlook

Barring a pandemic or other major external shocks, we have a positive outlook on business conditions in Hong Kong in 2006. However, the rate of economic growth is anticipated to be slower than that of last year due to high oil prices and higher interest rates.

Our rail business should benefit from economic growth as well as the full year impact of the opening of DRL. Economic activities may positively impact our station commercial and other businesses. However, the one-off income from termination of a telecommunication agreement in 2005 will not be repeated in 2006, and the intense competition among mobile network operators is likely to continue, as is the migration of 2G to 3G mobile telephony, all of which will negatively impact our telecommunications revenue. In our property rental business, significant renovation will take place in Telford Plaza to improve its competitive strength. This renovation programme is anticipated to slow rental revenue growth in 2006 but will benefit us in later years. As a result, the overall growth of non-fare revenue in 2006 is likely to be constrained.

In our property development business, projects along both the Airport Railway and Tseung Kwan O Line should contribute to profit. Along the Airport Railway, projects with deferred income will be recognised in accordance with construction progress and pre-sales. Given current market conditions we expect the remaining deferred income to be recognised largely over the next two years. In 2006, we also expect to receive an additional retail shell area of 7,685 square metres gross at Elements. Along the Tseung Kwan O Line, we expect booking of profit of developments at The Grandiose (Area 55b) for which the Occupation Permit was issued in January 2006 and, depending on the issuance of Occupation Permit, of Phase 1 of Metro Town (Tiu Keng Leng Station), comprising 1,676 units. It should be noted that in accordance with our accounting policy, when profit is recognised for Phase 1 of Metro Town, such recognition would be after deducting all costs for the whole development, including costs of Phase 2. Depending on sales progress, the remaining profit for the 390 units of development at Tseung Kwan O Town Centre Area 57a may also be booked in 2006.

Finally, I would like to take the opportunity to thank all of my colleagues for their strong contribution to another successful year for the Company.



C K Chow, *Chief Executive Officer*  
Hong Kong, 7 March 2006