Human Resources

The Company's success has been built on the commitment, caring service and professionalism of our staff. The Rail Merger created a significant opportunity for us to achieve "One Company, One Team".

During 2007, one of our top priorities was to prepare for the enlarged post-Rail Merger company and the key challenge was to maintain a stable workforce for the period leading up to the Appointed Day while also ensuring that staff resourcing for our growth business remained uninterrupted.

An internal newsletter was published regularly to give information on major milestones and merger issues, and staff were kept abreast of progress through various channels. A series of Cultural Integration Programmes was also launched for over 12,000 staff.

The Company takes its commitment to the community seriously. During the year, 86 activities were organised involving the elderly, the physically and mentally challenged, underprivileged children and families. In recognition of the Company's contributions to society, we were again awarded the Caring Company Logo 2007/08.

2007 was a particularly intensive year for the provision of training for the challenges of a new era. A series of training courses was organised to cultivate a mutual support working culture. Several major initiatives were undertaken to develop management talents. We trained 2,000 senior and junior supervisors in empathetic listening and conducted a series of seminars on doing business in China for senior supervisors.

In the CoMET Staff Exchange Programme, two senior supervisory staff were selected for a six-month secondment to London Underground in order to acquire experience of working in a country with a different culture and to benchmark best practices in their respective functional areas.

We continued to provide proactive training support to overseas projects such as Shenzhen Metro Line 4, Beijing Metro Line 4 and external consultancy. To support the new franchise of London Overground, we have stepped up resourcing efforts for the timely mobilisation of manpower.

To develop local metro industry talents in the Mainland of China, the Company signed cooperation agreements with Beijing Communication School in December to co-run a Training Centre to train quality personnel for the metro industry.

Financial Review

Review of 2007 Financial Results

Profit and Loss

Total revenues for 2007 increased by 12.0% to HK$10,690 million driven by the strong Hong Kong economy, continued expansion of our businesses and the Rail Merger effect from 2 December to the year end.

Fare revenue from Domestic Service (including KCR Lines after the Rail Merger) increased by 5.1% in 2007 to HK$6,213 million as a result of a 5.7% growth in patronage to 915.8 million and 0.6% decrease in average fare to HK$6.78. Fare revenue from Airport Express increased by 7.0% to HK$655 million with patronage growth of 6.3% to 10.2 million and average fare increasing 0.8% to HK$64.34. The Cross-boundary, Light Rail, Intercity and Bus services, which were part of the Rail Merger, contributed total revenue of HK$247 million and patronage of 22.4 million. Total fare revenues for the Company therefore increased by 9.1% to HK$7,115 million.

Revenues from station commercial and rail related businesses increased by 12.9% in 2007 to HK$1,741 million. With the Rail Merger and riding on the growing economy and increased patronage, revenues from advertising and station retail rose by 11.0% to HK$593 million and 27.6% to HK$499 million respectively. However, income from telecommunications decreased by 10.0% to HK$233 million. Consultancy income decreased slightly by 3.0% to HK$193 million.

Rental, management and other revenues increased by 24.3% in 2007 to HK$1,834 million, comprising HK$1,749 million of property rental and management income and HK$85 million of revenues from Ngong Ping 360. With the continued increase in rental rates, the opening of Phase 1 of Elements at Kowloon Station and Ginza Mall in Beijing, the expansion of our property management portfolio and the Rail Merger effect, property rental and management income recorded a strong growth of 23.9%.

Total operating costs, excluding merger related expenses, increased by 10.1% in 2007 to HK$4,778 million after accounting for the incremental operating costs following the Rail Merger in December. Costs relating to staff, energy and utilities and stores and spares increased by 9.0%, 6.9% and 8.3% respectively mainly due to the Rail Merger. Operational rent and rates increased by 52.3% mainly as a result of the Rail Merger and a one-off income in 2006 from settlement with the Government on rateable value assessment related to the Tseung Kwan O Line. Expenses relating to property ownership, management and other businesses increased by 56.5% mainly due to business expansion, additional costs for the opening of new shopping malls, the cable car operation at Ngong Ping 360 and the Rail Merger effect.

Operating profit from railway and related businesses before depreciation, amortisation and merger related expenses therefore increased by 13.7% to HK$5,912 million. Operating margin increased from 54.5% in 2006 to 55.3%.

Property development profit for 2007 increased significantly to HK$8,304 million from HK$5,817 million in 2006. This mainly comprised surplus proceeds from Le Point at Tiu Keng Leng Station and Harbour Green at Olympic Station, and deferred income mainly from Coastal Skyline and Caribbean Coast at Tung Chung Station and the fit-out works for Elements at Kowloon Station.

Operating profit before depreciation and amortisation therefore increased 29.0% to HK$14,216 million. Depreciation and amortisation charges for 2007 increased by 2.4% to HK$2,739 million due to the additional amortisation charge on Service Concession assets related to the Rail Merger as well as the full year depreciation charge on Ngong Ping 360 and other assets added to the network.

Due to substantial cash inflows during the early part of the year, interest and finance charges for 2007 declined by 5.9% to HK$1,316 million despite an increase in borrowings to fund the Rail Merger in December 2007 and an increase in average borrowing cost to 5.6% as compared to 5.5% in 2006. The gain from the increase in market value of investment properties amounted to HK$8,011 million before tax, which included HK$311 million of value appreciation on the investment properties acquired in the Rail Merger.

As part of the Rail Merger, the Company acquired certain property holding and other subsidiaries from KCRC and this combined with the takeover of operations of Ngong Ping 360 resulted in a net gain of HK$187 million. The Company's share of net profit of associates amounted to HK$99 million, including HK$97 million from Octopus Holdings Limited and HK$2 million from London Overground Rail Operations Ltd. Tax expenses, comprising mainly non-cash deferred tax provision, amounted to HK$3,083 million. Net profit for the Group in 2007 increased by 95.7% to HK$15,182 million, of which HK$15,180 million was attributable to equity shareholders. Earnings per share correspondingly increased from HK$1.41 in 2006 to HK$2.72 in 2007.

Excluding investment property revaluation and the related deferred tax provision, the underlying profit for the Group increased by 43.8% from HK$5,962 million in 2006 to HK$8,571 million. Earnings per share based on underlying profit increased by 42.6% from HK$1.08 in 2006 to HK$1.54 in 2007.

The Board has recommended a final dividend of HK$0.31 per share which, when added to the interim dividend of HK$0.14, will give a total dividend of HK$0.45 per share for the year. The final dividend, amounting to HK$1,740 million in total, offers a scrip dividend option to all shareholders except those with registered addresses in the United States of America or any of its territories or possessions. The Financial Secretary Incorporated has agreed to receive its entitlement to dividends in the form of shares to the extent necessary to ensure that a maximum of 50% of the Company's total dividend will be paid in cash.

Balance Sheet

The Group's balance sheet strengthened further in 2007. Total fixed assets increased to HK$132,417 million, mainly attributable to the addition of Service Concession assets and investment properties from the Rail Merger together with the surplus from investment property revaluation. Stores and spares increased from HK$272 million in 2006 to HK$642 million again mainly due to the acquisition of inventories from KCRC in the Rail Merger.

Railway construction in progress increased from HK$232 million in 2006 to HK$424 million as a result of the additional construction works on the new station at LOHAS Park project, partly offset by the transfer-out of the project costs on the SkyPlaza Platform at Airport Terminal Two upon its completion in February 2007.

Property development in progress increased significantly to HK$9,066 million, mainly due to the acquisition costs of property development rights in the Rail Merger. Properties held for sale amounted to HK$756 million, comprising mainly unsold residential units at Harbour Green in Olympic Station and The Arch at Kowloon Station.

Property management rights acquired in the Rail Merger amounted to HK$40 million, which was carried as an asset on the balance sheet subject to amortisation charge over the duration of the management contracts acquired.

Derivative financial assets and liabilities, representing the fair value of derivative financial instruments, were recorded at HK$273 million and HK$192 million respectively as compared to HK$195 million and HK$515 million respectively in 2006. The movements were mainly due to lower US interest rates and the weaker Hong Kong dollar forward exchange rates during the period.

Debtors, deposits and payments in advance increased significantly to HK$5,167 million primarily due to the increase in amounts receivable from pre-sale of residential units in Le Point at Tiu Keng Leng Station.

Total loans outstanding increased from HK$28,152 million in 2006 to HK$34,050 million mainly due to increased borrowing to fund the initial payments for the Rail Merger.

The amount due to KCRC at the year end was HK$975 million mainly in connection with the cost of property enabling works for KCRC property development sites that have not been tendered as well as a small amount of provision for the HK$750 million fixed annual payment for the Service Concession accrued for 2007. Reimbursement for such property enabling works will be received from developers on tender and will be paid over to KCRC.

Creditors, accrued charges and provisions increased from HK$3,639 million in 2006 to HK$5,412 million mainly attributable to the transfer of deposits on leases and certain other liabilities from KCRC in accordance with the Rail Merger agreements.

Deferred income decreased to HK$515 million, which relates primarily to profit to be recognised from Tung Chung and Kowloon station development packages in accordance with the progress of property construction and pre-sales.

With the recognition of tax on the profit for the year, including deferred tax provision for property revaluation, deferred tax liabilities increased to HK$12,574 million.

Share capital, share premium and capital reserve increased by HK$1,189 million to HK$39,828 million at the end of 2007 as a result of shares issued for scrip dividend and share options exercised. Together with increases in fixed asset revaluation and other reserves of HK$214 million and retained earnings net of dividends of HK$12,844 million, total equity attributable to equity shareholders increased to HK$91,014 million. Including the obligations under the Service Concession as a component of debt, the Group's net debt-to-equity ratio increased from 36.3% at 2006 year-end to 48.5% at 2007 year-end.

Cash Flow

The Company's cash position remained strong with net cash inflow generated from railway and related activities increasing to HK$5,965 million for the year, while cash receipts from developers and purchasers in respect of property development projects also increased to HK$5,824 million. Outflows for capital project payments, interest expenses, working capital and dividend payments amounted to HK$5,667 million. Hence, the Company recorded a net cash inflow of HK$6,122 million. After including the upfront payments of HK$12,040 million for the Rail Merger, and receipts of HK$786 million in respect of net cash for the assumption of certain KCRC assets and liabilities on the Appointed Day, there was a cash deficit of HK$5,132 million, which was financed by an increase in debt of HK$5,401 million. Cash balances at the year end increased by HK$269 million.

Financing Activities

New Financings

The Group's main financing activity was a HK$10 billion syndicated loan facility signed in October with a group of 19 major banks from Hong Kong, Mainland of China, Japan, Europe and the U.S., to meet our general corporate funding requirements, including partial settlement of the upfront payment to KCRC for the Rail Merger. This dual-tranche facility comprised a HK$3 billion 3-year term loan facility and a HK$7 billion 5-year revolving/term loan facility. The pricing and terms of the loan facility were amongst the most favourable in the Hong Kong dollar syndicated loan market, reflecting the strong financial position of the Group and the banking community's confidence in the Group's prospects.

As at the end of 2007, the Group had total undrawn committed facilities of HK$6.3 billion, which together with projected strong positive operating cash flows during 2008 and 2009, would provide sufficient coverage for contingency purposes or to meet unexpected demands.

Cost of Borrowing

Despite higher interest rates in the first half of the year, average borrowing cost in 2007 rose only slightly to 5.6% from 5.5% in 2006 due to the Group's prudent use of fixed and floating rate debt, as well as lower interest rates towards the year end.

Gross interest and finance charges (before interest income and impact from derivative financial instruments) decreased to HK$1,580 million, which also includes HK$60 million of notional interest relating to the capitalisation of the total fixed annual payments from the Rail Merger.

Risk Management

The cornerstone of our financing and risk management practices is our well-established Preferred Financing Model, which specifies the preferred mix of fixed and floating rate debt, the permitted level of currency exposure, a well-balanced spread of maturities, the use of different types of financing instruments, and an adequate length of financing horizon. With this disciplined approach, the Group was able to maintain a well diversified debt portfolio with adequate forward coverage of our future funding requirements.

We remain an active corporate user of derivative financial instruments, which are used solely for hedging purposes to reduce exposure to interest rate and currency risks. To control counterparty risk exposure, we deal only with counterparties that have a minimum credit rating of A-/A3, and assign limits of exposure to these counterparties in accordance with their credit ratings. In addition, the Company adopts a risk monitoring framework based on the widely accepted "value-at-risk" and "expected loss" concepts to further quantify and monitor those exposures.

Credit Ratings

We were the first Hong Kong corporate entity to obtain internationally recognised credit ratings and have since maintained strong ratings on a par with the Government.

In May, our foreign currency issuer and senior unsecured debt ratings of Aa3 were placed on review for possible upgrade by Moody's following its decision to place the Government's Aa3 rating on review for possible upgrade. Following the passage of the primary legislation for the Rail Merger Bill by LegCo, our ratings were upgraded to Aa2 with a stable outlook in July.

Standard & Poor's also affirmed our local and foreign currency long-term credit ratings at AA with a stable outlook and our A-1+ short-term corporate credit rating after considering the terms of the merger transaction and the strong support from the Government. Subsequently, the rating agency upgraded the outlook of our AA ratings to positive from stable, in line with its revision of the outlook on the Government's sovereign rating.

Rating & Investment Information, Inc. of Japan also affirmed our foreign currency and Hong Kong dollar issuer ratings at AA and short-term rating at a • 1+. and subsequently revised our ratings outlook to positive.

Financial Planning

We continued to use our comprehensive long-term financial planning model to plan our railway operations and to evaluate new projects and investments. This model subjects all investment proposals to rigorous evaluations that take into account our weighted average cost of capital and required rate of return. To ensure our assumptions are realistic and robust, we carefully review all key assumptions used in the model regularly and conduct sensitivity analyses on key scenarios. To manage our cost of capital effectively, we regularly conduct detailed assessment of our funding requirements and capital structure.

Financing Capacity

The Group's current projected capital expenditure programme comprises three parts – railway projects in Hong Kong, property projects in Hong Kong, and overseas investments. Based on the current programmes, total capital expenditures for the next three years between 2008 and 2010 are estimated at HK$11.2 billion for railway projects in Hong Kong, HK$1.1 billion for property investment in Hong Kong, and HK$5.9 billion for overseas investments, the bulk of the latter relates to Shenzhen Metro Line 4 if and when it is approved. These estimates, however, have not included the project costs of South Island Line (East) and the Kwun Tong Line extension in Hong Kong, where the bulk of such costs will be incurred after 2010.

With our strong financial position and robust cash flows, we are of the view that we will have sufficient financing capacity to fund the projected capital expenditure and to capture other potential investment opportunities.