Human Resources

The success of the Company is based on the commitment, professionalism and caring service of our staff. In reflection of the unity of our culture after the Rail Merger, the new grading and salary structure together with aligned terms and conditions for all Hong Kong staff were smoothly implemented across the entire organisation on 1 March 2008, with the selection and appointment process completed in April. A new set of Vision, Mission and Values (VMV) was developed and adopted across the Company. To ensure a high performance management culture, the performance management system was successfully revamped and launched to incorporate the new VMV.

The Company has long prided itself on commitment to the community. During the year, there were 87 volunteering projects involving the elderly, the physically and mentally challenged, and underprivileged children and families. In recognition of the Company's contributions to society, we were once again awarded by the Hong Kong Council of Social Service the Caring Company Logo for the year 2008/09.

A broad range of proactive training and development programmes was undertaken throughout the year to meet post-Rail merger challenges. We also focused on rules and safety qualification training in preparation for the launch of the new Railway Safety Rules for the merged Railway. Our strong commitment to training and development has gained recognition from global and local professional associations. Leadership development was proactively encouraged through ongoing programmes such as our Executive Associate Scheme and a Graduate Trainee programme with graduates from both Hong Kong SAR and the Mainland of China.

We continue to provide proactive training support to offshore projects. During the year, Mainland local recruits for BJL4 and SZL4 were given comprehensive training with job attachment in Hong Kong to ensure operational readiness of these two key new projects.

In Hong Kong, with the expansion of the railway network, substantial manpower resources are required for their planning, construction and operations. Early planning for the recruitment and retention of expertise commenced in 2008 and is making good progress.

Financial Review

Review of 2008 Financial Results

Profit and Loss

The Group's revenue and operating profit from recurring businesses achieved strong growth in 2008 with the full-year impact of the Rail Merger. Total revenue rose by 64.9% to HK$17,628 million while operating profit from railway and related businesses increased by 57.7% to HK$9,325 million.

Total fare revenue for 2008 increased by 61.2% to HK$11,467 million. Fare revenue from Domestic Service increased by 27.6% to HK$7,930 million as a result of a 31.6% increase in patronage to 1,205 million and a 3% decrease in average fare to HK$6.58. Fare revenue from Airport Express increased by 2.7% to HK$673 million with a patronage growth of 4.2% to 10.6 million and an average fare decrease of 1.4% to HK$63.47. Cross-boundary Service generated HK$2,283 million of fare revenue whilst Light Rail, Bus and Intercity services contributed a total of HK$581 million in fare revenue.

Revenues from station commercial and rail related businesses also recorded strong growth in 2008 with a 98.1% increase from last year to HK$3,449 million. Advertising revenue increased by 25% to HK$741 million. Revenue from station retail business rose 209.8% to HK$1,546 million and telecommunication income increased by 49% to HK$356 million. Consultancy business recorded a revenue decrease of 18.1% to HK$158 million.

Rental, management and other revenue in 2008 increased by 47.9% from last year to HK$2,712 million, with revenues from property rental and management in 2008 increasing by 46.1% to HK$2,556 million, reflecting the strong demand for office and retail space early on in the year, as well as the full-year effect of the opening of Elements. Ngong Ping 360 generated HK$156 million of revenue in 2008.

Total operating costs rose by 73.8% to HK$8,303 million in 2008, mainly due to the Rail Merger with increases in staff costs, energy and utilities, operational rent and rates, repairs and maintenance as well as general and administration expenses. In line with revenue growth, expenses relating to station commercial and rail related businesses increased by 100.5% while expenses relating to property ownership, management and other businesses increased by 45.4%.

Operating profit from railway and related businesses before depreciation and amortisation therefore increased by 57.7% to HK$9,325 million. Operating margin decreased from 55.3% in 2007 to 52.9% in 2008.

Profits on property developments in 2008 amounted to HK$4,670 million mainly from profit booking relating to The Capitol at LOHAS Park and The Palazzo in Shatin, and to a lesser extent, the sale of units in inventory at Harbour Green and The Arch, as well as deferred income recognition for properties at Coastal Skyline and Caribbean Coast at Tung Chung Station and Elements at Kowloon Station.

Depreciation and amortisation charges increased by 7% to HK$2,930 million due to the additional amortisation charge on service concession assets relating to the Rail Merger. Merger related expenses, comprising post-merger integration expenses not eligible for capitalisation, decreased by 72.5% to HK$53 million as a result of the one-off provision for Voluntary Separation Scheme payments in 2007.

Interest and finance charges increased by 51.8% to HK$1,998 million, mainly due to full year interest on debt and capitalised fixed annual payment, both for the Rail Merger. Average borrowing cost decreased to 4.8% from 5.6% in 2007. With the decline in property prices during the second half of the year, a net loss in investment property valuation of HK$146 million was recorded as compared with a net gain of HK$8,011 million last year. The Company's share of net profit from non-controlled subsidiaries and associates increased by 60.6% to HK$159 million, comprising HK$136 million from Octopus Holdings Limited and HK$23 million from London Overground Rail Operations Ltd.

Excluding investment property revaluation and the related deferred tax provision, net profit from underlying businesses attributable to equity shareholders decreased by 4.5% from HK$8,571 million to HK$8,185 million.

With the strong financial results, particularly from recurring businesses, the Board has recommended a final dividend of HK$0.34 per share, which when added to the interim dividend of HK$0.14 per share, will bring full year dividend to HK$0.48 per share, an increase of HK$0.03 per share or 6.7% compared with 2007. The final dividend, amounting to HK$1,925 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. As in previous years, The Financial Secretary Incorporated ("FSI") 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 2008 with a 7.5% increase in net assets from HK$91,037 million as at 31 December 2007 to HK$97,822 million as at 31 December 2008. Total fixed assets decreased from HK$132,417 million in 2007 to HK$131,004 million as at 31 December 2008 due to depreciation charges for the year.

Railway construction in progress, mainly related to the LOHAS Park Station project, increased from HK$424 million in 2007 to HK$658 million.

Property development in progress decreased from HK$9,066 million in 2007 to HK$7,895 million due to the transfer-out of the half land premium for The Capitol and acquisition cost for The Palazzo upon completion partly offset by the half land premium paid for the Che Kung Temple development site. Properties held for sale increased from HK$756 million in 2007 to HK$2,228 million, mainly comprising residential units at The Palazzo and The Arch as well as retail space at Island Harbourview. Property management rights decreased from HK$40 million in 2007 to HK$35 million due to amortisation.

Investment in securities increased from HK$333 million to HK$471 million. Derivative financial assets and liabilities increased from HK$273 million and HK$192 million respectively in 2007 to HK$528 million and HK$305 million as at 31 December 2008, mainly due to decline in interest rates during the period.

Debtors, deposits and payments in advance increased from HK$5,167 million in 2007 to HK$7,190 million as at 31 December 2008 due to the increase in accounts receivable relating to property development, which increased from HK$3,774 million to HK$5,818 million mainly on the receivable from pre-sales of units at The Capitol and The Palazzo.

Total loans outstanding decreased from HK$34,050 million in 2007 to HK$31,289 million, due to loan reduction from net cash generated during the year.

Amounts due to related parties included the Group's obligation to reimburse KCRC after tender award on the costs of property enabling works for certain KCRC property development sites and the accrued fixed annual payment for the service concession. The amount decreased from HK$975 million in 2007 to HK$882 million as at 31 December 2008, reflecting the reimbursement made to KCRC on the Che Kung Temple development upon tender award during the year.

Deferred income decreased from HK$515 million in 2007 to HK$156 million as at 31 December 2008 following profit recognition for Coastal Skyline and Caribbean Coast at Tung Chung Station and Elements at Kowloon Station.

With the Company's cumulative tax losses being full-utilised in 2008, provisional tax for the assessable year of 2008/09 of HK$575 million was paid in 2008. Current tax liabilities as at 31 December 2008 amounted to HK$450 million. Deferred tax liabilities decreased from HK$12,574 million in 2007 to HK$12,220 million, mainly due to the reduction in profits tax rate.

Share capital, share premium and capital reserve increased by HK$1,291 million to HK$41,119 million at the end of 2008 as a result of shares issued for scrip dividend and share options exercised. Together with the increase in retained earnings, net of dividends, of HK$5,796 million partly offset by the decrease in fixed asset revaluation reserve and other reserves of HK$300 million, total equity attributable to equity shareholders of the Company increased by HK$6,787 million to HK$97,801 million as at 31 December 2008. Including obligations under service concession as a component of debt, the Group's net debt-to-equity ratio decreased from 48.5% at 2007 year end to 42.1% at 2008 year end.

Cash Flow

Net cash inflow generated from railway and related activities increased from HK$5,974 million in 2007 to HK$8,921 million in 2008, while cash receipts from developers and purchasers in respect of property development projects decreased from HK$5,824 million in 2007 to HK$4,448 million in 2008 due to timing difference on property receipts. Outflows for capital projects and property developments increased by HK$3,407 million to HK$5,896 million. Net cash inflow, excluding non-recurring merger related payments, decreased from HK$6,477 million in 2007 to HK$4,014 million in 2008. Net cash inflow of the Group in 2008, after non-recurring merger related expenses of HK$316 million, amounted to HK$3,698 million, of which HK$3,538 million was used to reduce borrowings.

Financing Activities

New Financings

As the global financial crisis unfolded, the Group continued to be in a strong liquidity position, enjoying significant operating cash surplus and maintaining substantial undrawn committed banking facilities, all of them arranged prior to the crisis. Because of its well funded position, the Group did not embark on any major financing activities during the year. Instead, to further strengthen liquidity, it had chosen to tap, on an opportunistic basis, pockets of supply of Hong Kong dollars in the debt market via private placements. In this manner the Group raised a total of HK$1.75 billion during the year at highly attractive rate levels through note issuance from the debt issuance programme, reflecting investors' continued strong confidence in the Group.

As at the end of 2008, the Group had total undrawn committed facilities of HK$10.4 billion, which together with continuing strong operating cash flows are expected to meet all our cash requirements well into the second half of 2010.

Cost of Borrowing

Benefitting from declining interest rates, the Group's average borrowing cost for 2008 fell to 4.8% from 5.6% in 2007. However, net interest expense charged to the Profit and Loss Account, after interest capitalised of HK$149 million, rose to HK$1,998 million in 2008 from HK$1,316 million in 2007, mainly due to the full year impact of interest on additional borrowings to finance the Rail Merger as well as the interest element of HK$721 million on the capitalised fixed annual merger payments.

Treasury Risk Management

The Group's well established Preferred Financing Model (the "Model") is an integral part of our risk management policies. The Model specifies the preferred mix of fixed and floating rate debts, sources of funds from capital and loan markets, and debt maturity profile as well as a permitted level of foreign currency debts and an adequate length of financing horizon for coverage of forward funding requirements, against which the Group's financing related liquidity, interest rate and currency risk exposures are measured, monitored and controlled. During 2008, in accordance with the Model, the Group has maintained a well-diversified debt portfolio with adequate forward coverage of funding requirements.

The use of derivative financial instruments to control and hedge against interest rate and foreign exchange risk exposures forms an integral part of the Group's risk management strategy.

All derivative financial instruments are subject to a maximum counterparty limit based on the respective counterparty's credit ratings in accordance with policy approved by the Board. Credit exposure in terms of estimated fair market value of and largest potential loss arising from these instruments based on the "value-at-risk" concept is measured, monitored and controlled against respective counterparty limits.

The Group adopts a prudent approach to managing liquidity risk, and will maintain sufficient undrawn committed banking facilities to provide forward coverage of at least 6 to 15 months of all projected cash requirements, including debt repayments and capital expenditures, as specified by the Model. The Group also conducts stress testing of its projected cash flow to analyse liquidity risk, and would arrange additional banking facilities or debt issuance or otherwise take appropriate actions if necessary should such stress tests reveal significant risk of material cash flow shortfall.

Credit Ratings

The Company was the first Hong Kong corporate entity to obtain internationally recognised credit ratings and has since maintained strong investment grade ratings on a par with the Hong Kong SAR Government, reflecting its strong financial position and support from the Government.

In June, Moody's re-affirmed the Company's foreign currency issuer and senior unsecured debt ratings at Aa2 with a stable outlook, the same as the Hong Kong SAR Government. Subsequently in July, Standard & Poor's upgraded the Company's foreign currency issuer and senior unsecured debt ratings from AA to AA+ with a stable outlook, in line with the same corresponding upgrade of the sovereign rating for the Hong Kong SAR Government.

In August, Rating & Investment Inc. of Japan raised the Company's foreign currency issuer and Hong Kong dollar issuer ratings to AA+ from AA, and re-affirmed its Hong Kong dollar short-term credit rating at a • 1+, with a stable outlook.

Financing Capacity

The Group's capital expenditure programme consists mainly of three parts – railway projects in Hong Kong, property investment and development in Hong Kong, and overseas investments.

Capital expenditure for railway projects in Hong Kong comprises mainly investment in and expenditures relating to new railway projects, such as the West Island Line, South Island Line East and Kwun Tong Line Extension, as well as outlays for maintaining and upgrading the existing rail lines. For property investment and development, it comprises mainly the remaining fit-out works for Elements, fit-out works for the retail areas of The Capitol and Tseung Kwan O Area 56, common infrastructure works for the Area 86 development sites, as well as renovation of various existing shopping centres in Hong Kong. For overseas investments, it consists mainly of equity contribution to Shenzhen Metro Line 4.

Based on current programmes, total capital expenditures for the next three years of 2009, 2010 and 2011 are estimated at HK$23.3 billion for railway projects in Hong Kong, HK$1.0 billion for property investment and development in Hong Kong, and HK$1.9 billion for overseas investments, mainly our equity contribution to Shenzhen Metro Line 4. Out of this total budget of HK$26.2 billion, an estimated amount of HK$6.0 billion is expected to be incurred in 2009, HK$5.9 billion in 2010, and HK$14.3 billion in 2011. These numbers exclude Government grants receivable for West Island Line. Our current financing coverage horizon extends into the second half of 2010.

With the current global financial crisis continuing to develop, fund raising in the capital and loan markets will remain difficult in the foreseeable future. However, with our well funded situation, significant forward coverage, and continuing support from investors, we remain confident that we will attract the necessary funds for our capital expenditure programme.