Financial Review

Review of 2009 Financial Results

Profit and Loss

With the commencement of international railway concessions in Stockholm and Melbourne, total revenues in 2009 grew by 6.6% to HK$18,797 million while operating profit from railway and related businesses rose 1.9% to HK$9,502 million.

Total Hong Kong fare revenue for 2009 increased marginally by 0.3% to HK$11,498 million. Fare revenue from Domestic Service grew 0.7% to HK$7,986 million with patronage growth of 1.1% to 1,218.8 million partly offset by a drop in average fare of 0.4% to HK$6.55. Fare revenue from Cross-boundary Service increased by 1.9% to HK$2,327 million with patronage and average fare increasing by 0.7% to 94 million and 1.2% to HK$24.75 respectively. Airport Express recorded a revenue decline of 8.3% to HK$617 million attributable to a 6.9% drop in patronage to 9.9 million and a 1.6% decrease in average fare to HK$62.48. Fare revenues from Light Rail, Bus and Intercity totaled HK$568 million.

Revenue from station commercial and rail related businesses decreased 3.5% to HK$3,328 million in 2009. Advertising revenue dropped by 19.4% to HK$597 million while revenue from station retail business increased by 3.8% to HK$1,605 million. Telecommunication income dropped by 23.3% to HK$273 million. Consultancy revenue was at a similar level to 2008 at HK$159 million while miscellaneous income grew 7.1% to HK$694 million.

Rental, management and other revenue in 2009 increased by 8.0% to HK$2,928 million, with revenue from property rental and management rising 7.8% to HK$2,755 million and revenue from Ngong Ping 360 increasing by 10.9% to HK$173 million.

The takeover of Stockholm Metro and Melbourne Train operations and maintenance in November 2009 generated additional revenue from these franchises of HK$494 million and HK$549 million respectively in 2009. Excluding these two revenue streams, total revenue in 2009 was marginally higher than last year by 0.7%.

Total operating costs before depreciation and amortisation in 2009 were HK$9,295 million, an increase of 11.9% mainly due to the costs incurred in the operations of Stockholm Metro and Melbourne Train. Excluding the operating costs of these two international franchises, total operating expenses would have shown a decrease of 0.5%, mainly due to lower station commercial and rail related businesses expenditure. Cost control measures in place during the year limited the increases in a number of expenses such as staff costs and related expenses.

Operating profit from railway and related businesses before depreciation and amortisation therefore increased by 1.9% to HK$9,502 million. Owing to the inclusion of the asset-light, hence lower profit margin railway franchises of Stockholm Metro and Melbourne Train, operating margin decreased from 52.9% in 2008 to 50.6% in 2009. Excluding these two franchises, operating margin would have increased to 53.5%.

Profits from property development were lower in 2009 by 23.9% when compared to 2008 due mainly to the timing of profit bookings. Property development profits in the year were HK$3,554 million mainly comprising profits relating to The Harbourside at Kowloon Station, The Palazzo, The Capitol as well as Lake Silver at Wu Kai Sha Station.

Depreciation and amortisation charges increased by 1.7% to HK$2,979 million while remaining expenses relating to merger integration were HK$12 million.

Interest and finance charges decreased by 24.7% to HK$1,504 million, reflecting the decrease in average borrowing cost from 4.8% per annum in 2008 to 3.7% and the reduced level of debt outstanding. In light of positive sentiments on the property market, a net pre-tax gain in investment property revaluation of HK$2,798 million was recorded as compared with a net loss of HK$146 million in 2008. The Group's share of net profit from non-controlled subsidiaries and associates was HK$160 million, mainly comprising HK$149 million from Octopus Holdings Limited, HK$17 million from the London Overground Concession and a loss of HK$5 million from Beijing Metro Line 4.

Excluding investment property revaluation and the related deferred tax provision, the underlying profit attributable to equity shareholders decreased by 10.8% from HK$8,185 million to HK$7,303 million.

With good results and strong cash flow in our businesses the Board has recommended a final dividend of HK$0.38 per share, which, when added to the interim dividend of HK$0.14 per share, will bring full year dividend to HK$0.52 per share, an increase of HK$0.04 per share or 8.3% compared with 2008. The final dividend, amounting to HK$2,177 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. Our financial year ending 31 December 2009 marks the last year in which 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. Going forward, subject to the financial conditions of the Company, the Board intends to follow a progressive dividend policy.

Balance Sheet

The Group's balance sheet strengthened further with an 8.8% increase in net assets from HK$97,822 million as at 31 December 2008 to HK$106,453 million as at 31 December 2009.

Total fixed assets increased from HK$131,004 million in 2008 to HK$137,634 million as at 31 December 2009 mainly due to further investment in SZL4 and the revaluation gain in investment properties.

Railway construction in progress had no balance at the end of 2009 as construction costs incurred in the West Island Line were netted off by the Government funding support and the total costs for LOHAS Park Station were transferred to fixed assets upon opening.

Property development in progress decreased from HK$7,895 million in 2008 to HK$6,718 million as the acquisition costs for the development rights of Lake Silver were taken to the profit and loss account upon development completion. Properties held for sale increased from HK$2,228 million to HK$3,783 million as unsold residential units at Lake Silver were added to inventory.

Investment in securities decreased from HK$471 million to HK$227 million due to disposal of investments. Derivative financial assets and liabilities were recorded at HK$370 million and HK$237 million respectively as at 31 December 2009 as compared to HK$528 million and HK$305 million in 2008. Stores and spares increased from HK$690 million in 2008 to HK$1,040 million as higher levels of critical spares were maintained and additional stores and spares were taken up for the Stockholm Metro and Melbourne Train.

Debtors, deposits and payments in advance decreased from HK$7,190 million in 2008 to HK$2,428 million as at 31 December 2009 following cash receipts from purchasers of units at The Capitol and The Palazzo. Loan to a property developer decreased from HK$3,720 million in 2008 to HK$1,916 million due to a scheduled repayment of HK$2,000 million in 2009. Amounts due from the Government and other related parties increased from HK$426 million in 2008 to HK$12,788 million due mainly to the Government funding support for the West Island Line of HK$12,252 million to be received later in March 2010.

Total loans outstanding decreased from HK$31,289 million in 2008 to HK$23,868 million as surplus cash generated from our businesses was applied to repayment of loans.

Creditors and accrued charges increased from HK$5,334 million to HK$20,497 million, attributable to the un-utilised portion of the Government funding support for the West Island Line and the deposits received from the sale of property development units at Le Prestige.

Amounts due to the Government and a related party increased from HK$882 million in 2008 to HK$923 million as at 31 December 2009 mainly due to interest accrued on the costs of property enabling works reimbursable to KCRC.

Loan from minority shareholders of a subsidiary at the end of 2009 of HK$136 million represented the portion of shareholders' loan provided to MTM by the 40% minority shareholders of MTM.

Deferred income increased from HK$156 million in 2008 to HK$167 million as at 31 December 2009, comprising HK$124 million relating to property development and HK$43 million relating to the telecommunication business.

Current tax liabilities decreased from HK$450 million to HK$430 million as at 31 December 2009. Deferred tax liabilities increased from HK$12,220 million in 2008 to HK$12,804 million mainly due to deferred tax provision on investment property revaluation.

Share capital, share premium and capital reserve increased by HK$1,378 million to HK$42,497 million at the end of 2009. Together with the increases in retained earnings net of dividends paid, fixed assets revaluation reserve and other reserves, total equity attributable to shareholders of the Company increased by HK$8,586 million to HK$106,387 million as at 31 December 2009. Including obligations under the service concession and loan from minority shareholders of a subsidiary as components of debt, the Group's net debt-to-equity ratio decreased from 42.1% at 2008 year end to 25.8% at 2009 year end.

Cash Flow

Net cash inflow from railway and related activities after tax payments decreased by 9.1% to HK$8,107 million due to higher tax paid following the full-utilisation of cumulative tax losses in 2008. During the year, substantial amounts of cash in respect of property developments were received, including HK$11,784 million from property purchasers coupled with HK$2,000 million of scheduled loan repayment from the developer of LOHAS Park Package Two. Including net proceeds from sales of investment in securities, dividend income, net cash receipts in respect of investments in non-controlled subsidiaries and associates as well as proceeds from disposal of fixed assets, total cash inflow for 2009 was HK$22,344 million.

Cash outflows for capital projects and property developments were HK$5,391 million, principally for the purchase of railway operational assets and railway extension projects in Hong Kong, construction of SZL4 as well as property renovation and development projects. After settlement of fixed annual payment on service concession, equity injection to the associates for Shenyang Metro Lines 1 and 2 and the Stockholm rolling stock maintenance company, interest and dividend payments as well as change in working capital, a net cash inflow of HK$13,654 million was generated before loan repayment and borrowings. After a net loan repayment of HK$7,294 million, cash balance of the Group increased by HK$6,360 million to HK$7,094 million as at 31 December 2009.

Financing Activities

New Financings

Corporate borrowing activities in Hong Kong were slow in the first half of the year with credits being extended mostly to top-rated borrowers as major banks remained cautious. As economic conditions continued to improve, loan and debt issuance volume grew significantly in the second half.

Throughout the year, the Group remained in a very strong liquidity position, enjoying significant operating cash surplus from operations and property development activities. With strong cash flows and substantial committed undrawn banking facilities, we did not undertake any significant debt issuance during the year, with the HK$500 million 5-year fixed rate medium term note issued earlier in the year being our only debt issuance in 2009.

In the Mainland of China, following the signing of the Concession Agreement for SZL4, the Group in May formally concluded a RMB4.0 billion financing agreement for the project that comprises a RMB3.6 billion 20-year term loan and other facilities.

Cost of Borrowing

The Group's average borrowing cost for 2009 fell to 3.7% from 4.8% in 2008. Net interest expense charged to the Profit and Loss Account, after interest capitalised of HK$139 million, fell to HK$1,504 million in 2009 from HK$1,998 million in 2008 due to reduced borrowings and lower interest rates.

Treasury Risk Management

The Group's well established Preferred Financing Model (the "Model") is an integral part of these 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 2009, in accordance with the Model, the Group 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 of the derivative instruments used by the Group are over-the-counter derivatives comprising principally interest rate swaps, cross currency swaps and foreign exchange forward contracts.

To control and diversify counterparty risks, the Group limits its exposure to credit risk by placing deposits and transacting derivative financial instruments only with financial institutions with acceptable investment grade credit ratings.

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 their respective counterparty limits.

The Group adopts a prudent approach to managing liquidity risk, and will maintain sufficient cash balance and 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, Standard & Poor's placed the Company's AA+ long-term corporate and issue ratings on CreditWatch upon announcement of a revised methodology for rating government-related entities. In October, after further analysis, our AA+ ratings were affirmed by the agency with a stable outlook, which is the same as the Hong Kong SAR Government sovereign ratings.

In November, Moody's upgraded their outlook on the Company's Aa2 foreign currency issuer and senior unsecured debt ratings to positive from stable, following a similar decision to change the outlook on Hong Kong SAR Government's Aa2 sovereign bond ratings to positive.

Rating & Investment Inc. of Japan maintained the Company's issuer rating at AA+ and short-term debts 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 investments outside of Hong Kong.

Capital expenditure for railway projects in Hong Kong comprises mainly investment in and expenditures relating to new railway projects, including ownership projects such as the West Island Line, South Island Line (East) and the Kwun Tong Line Extension, as well as outlays for maintaining and upgrading the existing rail lines. Concession projects such as the Shatin to Central Link and Express Rail Link will be fully funded by the Government.

Capital expenditure for property investment and development comprises mainly investments in shopping centres, including renovation works, investments for property development such as part payment of land premiums and payment for infrastructure and enabling works. Expenditure for investments outside of Hong Kong consists primarily of capital expenditure for SZL4 and equity injection for Hangzhou Metro Line 1.

Based on current programmes and before netting off the Government funding support for the West Island Line, total net capital expenditures for the next three years of 2010, 2011 and 2012 are estimated at HK$32.5 billion for railway projects in Hong Kong, HK$8.2 billion for property investment and development in Hong Kong, and HK$6.8 billion for investments outside of Hong Kong, totalling HK$47.5 billion. Out of this total, an estimated amount of HK$17.6 billion is expected to be incurred in 2010, HK$16.5 billion in 2011, and HK$13.4 billion in 2012.

With forward financing coverage extending to the second half of 2012, it is estimated that funding for capital expenditures estimated for 2010, 2011 and most of 2012 as well as for debt refinancing during the period would be adequately covered by the Group's existing cash surplus and undrawn committed facilities as well as future projected cash flows and the Government's funding support for the West Island Line.