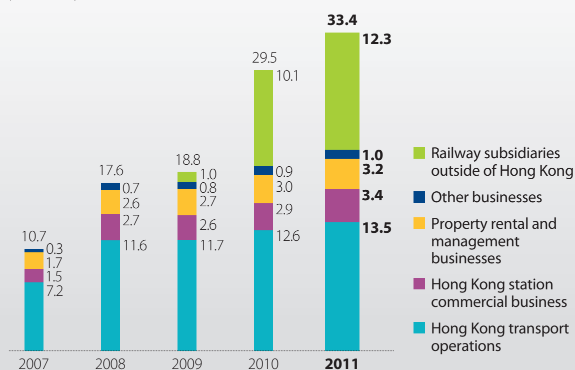
FINANCIAL REVIEW

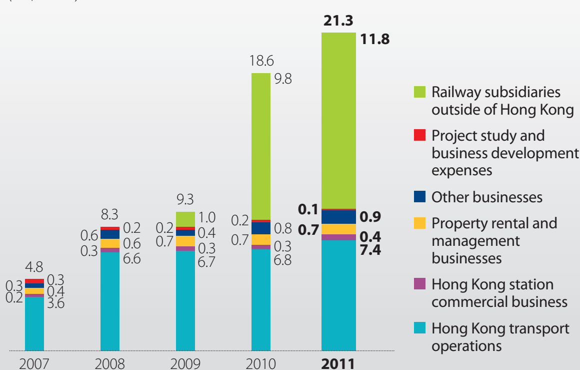
TURNOVER

With the continued economic growth in Hong Kong and improved performance of railway subsidiaries outside of Hong Kong, turnover in 2011 reported a record peak of HK$33.4 billion.



OPERATING EXPENSES

Besides supporting the revenue growth, more operating expenses were incurred in 2011 for service enhancement and compliance with the Minimum Wage Ordinance.



REVIEW OF 2011 FINANCIAL RESULTS

Profit and Loss

In 2011, the Group leveraged off continued economic growth in Hong Kong to achieve another year of good financial results.

During the year, Hong Kong fare revenue increased by 7.2% to HK$13,357 million, attributable to higher patronage brought about by the economic growth and the increase in average fare for eligible services under the Fare Adjustment Mechanism (FAM). Patronage of Domestic Service, Cross-boundary Service and Airport Express rose by 5.2%, 3.9% and 5.9% respectively. Average fares for Domestic Service and Cross-boundary Service, which are subject to FAM, increased by 2.0% and 1.8% respectively, while that for Airport Express, which is not subject to FAM, increased by 2.1% due to a change in passenger mix. Fare revenue from Domestic Service, Cross-boundary Service and Airport Express therefore increased by 7.3%, 5.9% and 8.2% respectively to HK$9,300 million, HK$2,633 million and HK$751 million. Light Rail, Bus and Intercity also recorded increases in fare revenue in total by 10.3% to HK$673 million. Including other rail related income of HK$152 million, revenue from Hong Kong transport operations in 2011 increased by 6.9% to HK$13,509 million. Expenses relating to Hong Kong transport operations increased by 7.8% to HK$7,354 million mainly due to an increase in manpower and maintenance works for service enhancements, extra costs incurred for complying with the Minimum Wage Ordinance as well as higher payments for Government rent and rates. Operating profit from Hong Kong transport operations in 2011 was HK$6,155 million, an increase of 5.9% compared with last year.

Hong Kong station commercial business also benefited from the sustained economic growth. Revenue in 2011, which included certain receivables in relation to the termination of 2G telecommunication contracts, was HK$3,422 million, 19.9% higher than last year. The revenue growth excluding such one-off receivables was 13.9% as a result of the strong advertising market, increases in rental rate and lettable floor area of our station retail business as well as additional telecommunication income from the enhancement of 3G coverage. Expenses relating to Hong Kong station commercial business was HK$358 million, an increase of 21.8%. Operating profit from Hong Kong station commercial business in 2011 increased by 19.7% from last year to HK$3,064 million.

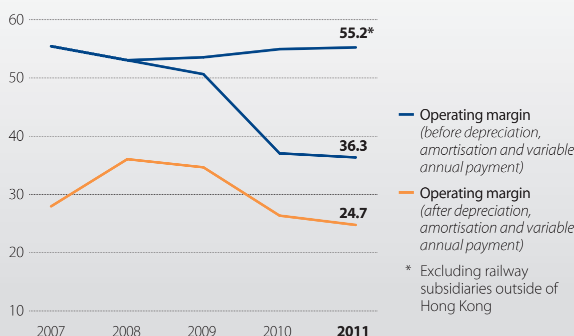
Revenue from property rental and management businesses in 2011 was HK$3,215 million, an increase of 8.6% with rental income increasing by 9.4% but partially offset by the decrease in property management income of 2.0%. The rise in property rental income to HK$3,016 million was mainly due to the favourable rental reversion and higher turnover rent collected from retail tenants. The decrease in property management income to HK$199 million was due to the alignment of the manager's remuneration rate to maintain competitiveness. Expenses relating to property rental and management businesses, including additional costs for complying with the Minimum Wage Ordinance, increased by 10.2% to HK$721 million. Operating profit from property rental and management businesses in 2011 was HK$2,494 million, an increase of 8.1% from last year.

Railway subsidiaries outside of Hong Kong in 2011 reported a 60.9% growth in operating profit to HK$449 million. MTRS made a significant improvement in performance with an operating profit of HK$55 million as compared to an operating loss of HK$6 million in 2010. MTM reported a 22.7% increase in operating profit to HK$400 million mainly due to more project works as well as favourable currency movements. In Shenzhen, Phase 2 of the Longhua Line opened on 16 June 2011. Together with Phase 1, the operation of which was

OPERATING MARGIN

Excluding railway subsidiaries outside of Hong Kong, operating margin improved steadily since the Rail Merger to 55.2% in 2011.

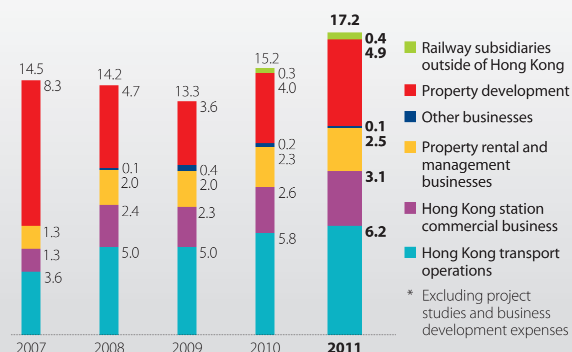
(Percentage)



OPERATING PROFIT CONTRIBUTIONS*

Except for property development and other businesses, all business segments achieved steady growth in operating profit, which accounted for 71% of the Group's total in 2011.

(HK$ billion)



taken over by the Group in July 2010, the SZL4 recorded a better-than-expected operating loss of HK$68 million in 2011. Including the recognition of HK$62 million of compensation subsidy from the Shenzhen Municipal Government, the SZL4 reported a slight operating loss of HK$6 million, as compared with a HK$41 million loss in 2010.

Other businesses, comprising mainly Ngong Ping 360, consultancy business and project management service to the Government for the Express Rail Link construction, generated an operating profit of HK$85 million, a 51.1% decrease from last year. The decrease was mainly due to the completion of the Kowloon Southern Link project in 2010 with the receipt of the last tranche of management incentive fees for that project also in 2010.

Including expenses on project studies and new business development of HK$123 million, which decreased by 43.1% due to reduced Mainland business development expenses in 2011, operating profit before property developments, depreciation, amortisation and variable annual payment increased by 11.1% to HK$12,124 million. Owing to the increased contribution weighting from the asset-light, lower-margin international railway subsidiaries and the initial operating loss of the SZL4, operating profit margin in 2011 reduced slightly from 37.0% in 2010 to 36.3%. Excluding these railway subsidiaries outside of Hong Kong, the margin improved from 54.9% in 2010 to 55.2% in 2011.

Property development profit in 2011, mainly relating to the Festival City development and the shopping mall at Tseung Kwan O Area 56, increased by 22.3% to HK$4,934 million. Depreciation and amortisation increased by 2.8% to HK$3,206 million as a result of additional charges on assets commissioned such as the new trains and additional concession properties. Including the first full-year charge of variable annual payment to KCRC of HK$647 million, compared to the one-month charge of HK$45 million in 2010, operating profit before interest and finance charges increased by 12.0% to HK$13,205 million.

With reductions in the average net debt balance and the amount of fixed rate debts, which carried higher interest rates, interest and finance charges in 2011 decreased by 25.5% to HK$921 million while the weighted average cost of borrowing decreased from 4.3% in 2010 to 3.1%. Investment property revaluation gain recognised in 2011 was HK$5,088 million. Share of profits of non-controlled subsidiaries and associates was HK$297 million, a 113.7% increase from last year mainly due to the improvement in profit of Octopus Holdings Limited and better-than-expected performance of BJMTR, our share of which increased from break-even in 2010 to a profit of HK$84 million in 2011.

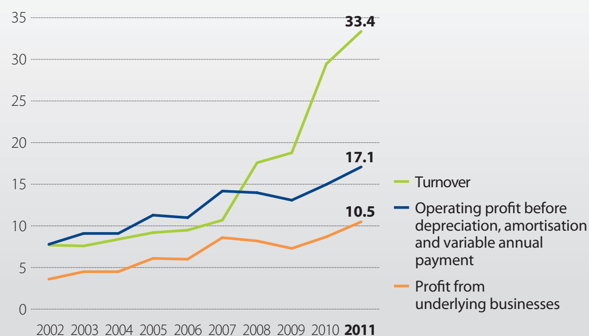
Profit before taxation increased by 19.7% to HK$17,669 million. After deducting income tax of HK$2,821 million, profit for 2011 increased by 22.0% to HK$14,848 million, of which HK$14,716 million was attributable to equity shareholders of the Company. Earnings per share therefore increased from HK$2.10 in 2010 to HK$2.55 in 2011. Excluding investment property revaluation and the related deferred tax provision of HK$4,248 million, the underlying profit attributable to equity shareholders was HK$10,468 million, of which HK$4,225 million was derived from property developments and HK$6,243 million from other businesses. Earnings per share based on our underlying profit increased from HK$1.51 in 2010 to HK$1.81 in 2011.

The Board has recommended a final dividend of HK$0.51 per share, which, when added to the interim dividend of HK$0.25 per share, will bring full year dividend to HK$0.76 per share, an increase of HK$0.17 per share or 28.8% from last year.

NET RESULTS FROM UNDERLYING BUSINESSES

Underlying business profit in 2011 further increased to a record peak of HK$10.5 billion.

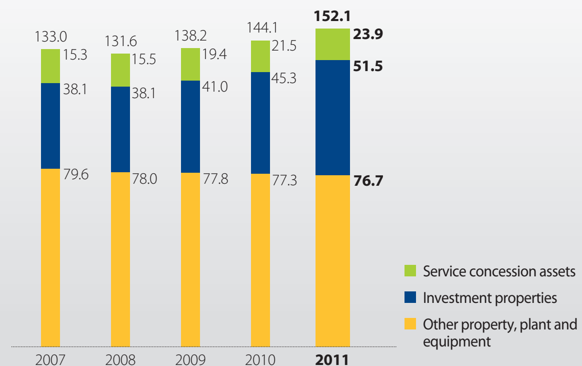
(HK$ billion)



FIXED ASSETS GROWTH

Fixed assets at 2011 year-end further increased to HK$152.1 billion with the revaluation gains in investment properties and asset additions for the railway extensions in Hong Kong and the SZL4 in the Mainland of China.

(HK$ billion)



Balance Sheet

The Group's balance sheet further strengthened during the year. As at 31 December 2011, net assets amounted to HK$129,045 million, an increase of 10.0% from 2010 year-end with total assets increasing by 8.9% to HK$197,873 million and total liabilities increasing by 6.9% to HK$68,828 million.

Total fixed assets increased by HK$8,011 million to HK$152,068 million mainly due to the revaluation gain on investment properties, receipt of our share of the shopping mall at Tseung Kwan O Area 56 as well as further construction and completion of the SZL4. Upon signing of the project agreements for the construction of South Island Line (East) and Kwun Tong Line Extension in 2011, the associated costs of HK$1,057 million incurred in prior years were transferred from deferred expenditure to railway construction in progress and property development in progress. As at 31 December 2011, railway construction in progress was HK$3,566 million, which excluded the cumulative West Island Line construction costs of HK$8,039 million incurred but fully offset by the Government grant of HK$12,652 million previously received. Property development in progress increased by HK$2,836 million to HK$11,964 million, mainly due to the land cost for the SZL4 Depot site and preliminary work done for the Wong Chuk Hang site on the South Island Line (East).

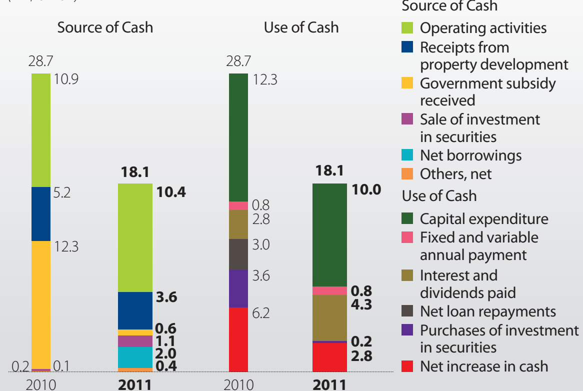
Properties held for sale increased by HK$1,821 million to HK$3,757 million at 2011 year-end mainly due to recognition of units in inventory relating to Festival City at Tai Wai. Debtors, deposits and payments in advance increased by HK$903 million to HK$3,964 million mainly due to the increase in receivables relating to flats sold at Festival City and telecommunication income from the 2G contract termination. During the year, the loan to the developer of Le Prestige at LOHAS Park, amounting to HK$1,975 million at 2010 year-end, was fully repaid while investments in medium term notes of HK$1,000 million were redeemed upon maturity. Cash, bank balances and deposits increased by HK$2,766 million to HK$16,100 million.

On the liability side, the increase in total liabilities of HK$4,456 million was mainly due to the increase in total loan outstanding of HK$2,111 million to HK$23,168 million, the increase in total tax liabilities of HK$830 million to HK$15,702 million, inclusive of HK$15,105 million of deferred tax provision, and the amount of land premium less deposit paid for the SZL4 Depot site of HK$1,950 million. During the year, HK$1,233 million (RMB1 billion) of Renminbi denominated notes were issued in June to finance the SZL4 while HK$1,000 million of five-year medium term notes were issued in December. Creditors and accrued charges increased by HK$911 million to HK$16,402 million due to land cost payable for the SZL4 Depot site, the increase in project accruals for the SZL4, South Island Line (East) and Kwun Tong Line Extension as well as project management fee received in advance for the Express Rail Link partly offset by the utilisation of the West Island Line Government grant.

Share capital, share premium and capital reserve increased by HK$328 million to HK$44,062 million resulting from shares issued for scrip dividends and share options exercised. Together with the increase in retained earnings net of dividends paid of HK$10,677 million and increase in fixed asset revaluation reserve and other reserves of HK$704 million, total equity attributable to shareholders of the Company increased by HK$11,709 million to HK$128,859 million at 31 December 2011. The net debt-to-equity ratio decreased from 12.8% at 2010 year-end to 11.9% at 2011 year-end.

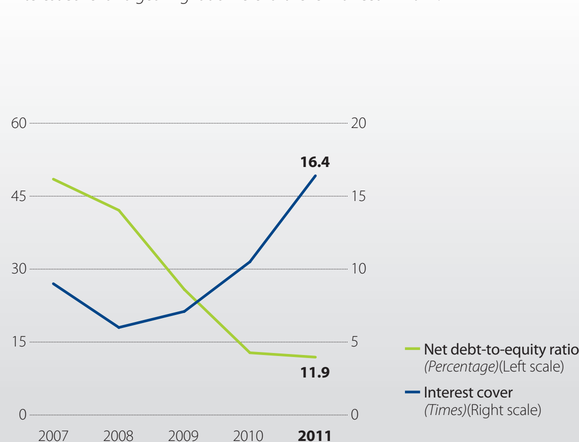
CASH UTILISATION

Cash inflows mainly from operating activities and property developments in 2011 were utilised to pay off mainly capital expenditures, interest expense and dividends.



DEBT SERVICING CAPABILITY

Interest cover and gearing ratio were further enhanced in 2011.



Cash Flow

Cash inflow generated from operating activities of the Group before cash tax payment in 2011 increased by 4.8% to HK$12,489 million. After accounting for the receipt of government subsidy for the SZL4 of HK$638 million (RMB522 million) and cash tax payment of HK$2,103 million, net cash inflow from operating activities was HK$11,024 million, a slight increase of 1.1% from last year. Total cash receipts from property developments was HK$3,593 million, comprising the scheduled final loan repayment of HK$2,000 million from a developer and settlement of receivables mainly on The Palazzo and Lake Silver. Including other cash receipts such as dividend from Octopus Holdings Limited and recovery of Government entrustment works, total cash inflow in 2011 was HK$14,965 million.

Total capital expenditure outflows in 2011 was HK$10,043 million, including HK$2,102 million for the purchase of assets for Hong Kong transport and related operations, HK$5,028 million for the West Island Line, South Island Line (East) and Kwun Tong Line Extension projects, HK$1,385 million for SZL4 Phase 2 construction and HK$1,330 million for property developments, renovation and fitting-out works. After settlement of the fixed and variable annual payments of HK$795 million, net interest payment of HK$421 million, dividend payments of HK$3,842 million and other working capital adjustments, total cash outflow of the Group in 2011 was HK$15,162 million.

As a result, the Group recorded a net cash outflow of HK$197 million, which was covered by the redemption of medium term notes amounting to HK$1,000 million. Including a net loan drawdown of HK$1,979 million, the Group's cash balance increased by HK$2,782 million to HK$16,100 million at 31 December 2011.

Financing Activities

Financings

Despite continued quantitative easing by the Fed, growth in the U.S. and developed economies remained fragile for much of 2011. Anaemic growth, together with increased demand for US treasuries due to the European sovereign debt situation, helped push treasury yields towards historical lows.

Conditions in the financial markets deteriorated significantly in the third quarter as the European sovereign debt situation worsened resulting in perception of higher bank counterparty risks. This helped further decrease banking liquidity and increase bank funding costs.

In the circumstances, the Fed and most central banks continued to pursue extremely loose monetary policies with the Fed indicating its commitment to a 0-0.25% Fed Funds rate for an extended period of time and implementing other measures to keep long-term rates low.

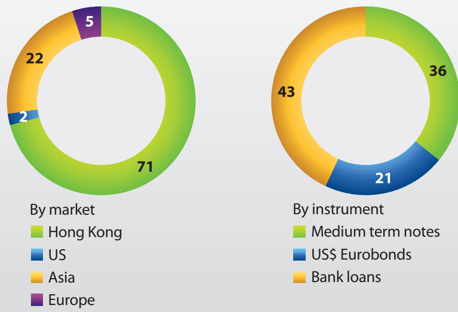
Short-term interest rates in Hong Kong remained soft during the year albeit on a slight uptrend with 3-month Hibor rate rising and closing the year at 0.38% per annum, to partly reflect higher bank funding costs. Long-term rates, however, remained on a downtrend with yield on the 10-year Exchange Fund Notes ending the year at 1.4% per annum.

Loan demand in Hong Kong was strong in 2011 contributed in part by increased Mainland and related borrowers' funding activities in Hong Kong and by local refinancings. Significant loan demand coupled with banks' continual reduction in leverage resulted in a sharp increase in borrowing costs.

SOURCES OF BORROWING

Although Hong Kong is our main market, our strategy is to diversify our funding sources and maintain ready access to other important international markets.

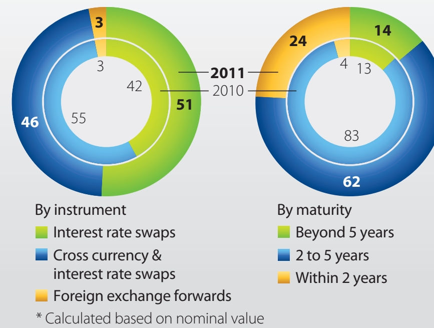
(Percentage) (As at 31 December 2011)



USE OF INTEREST RATE AND CURRENCY RISK HEDGING PRODUCTS

The Company has a strict policy of limiting the use of derivatives financial instruments for hedging purposes only.

(Percentage) (As at 31 December 2011)*



* Calculated based on nominal value

During the year, the Group remained in a very strong liquid position and adopted an opportunistic approach to new financing. New financings were concluded either to capture attractive funding opportunities to reduce overall cost, or to further strengthen liquidity ahead of future funding requirements.

In June, the Group came to the market with a debut 2-year RMB1 billion Dim Sum Bond issue with a historical low coupon rate of 0.625% per annum. Proceeds of the issue were remitted as a shareholder's loan to SZMTR to fund remaining capital expenditure of SZL4 and to lower overall borrowing cost.

This was followed in December by a HK$1 billion 5-year note issued from the Group's debt issuance programme with proceeds added to the Group's liquidity pool for meeting future funding requirements.

Cost of Borrowing

The Group's consolidated debt position increased from HK$21,057 million at 2010 year-end to HK$23,168 million at 2011 year-end. Weighted average borrowing cost declined to 3.1% per annum from 4.3% per annum in 2010 due to continuing low interest rates and reduction in average fixed rate debt level with higher interest rates. Therefore, net interest expense charged to the Profit and Loss Account, after interest capitalised of HK$96 million and off-setting part of SZL4 government subsidy of HK$133 million, declined to HK$921 million from HK$1,237 million in 2010.

Treasury Risk Management

The Board of Directors approves policies for overall treasury risk management covering areas of liquidity risk, interest rate risk, foreign exchange risk, credit risk, concentration risk, use of derivative financial instruments, and investment of excess liquidity.

The Group's well established Preferred Financing Model (the "Model") is an integral part of our risk management policy. 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 financing related liquidity, interest rate and currency risks are monitored and controlled.

In accordance with Board policy, derivative financial instruments shall only be used for controlling or hedging risk exposures, and not for speculation. Derivative instruments currently used by the Group are over-the-counter derivatives comprising mainly interest rate swaps, cross currency swaps and foreign exchange forward contracts.

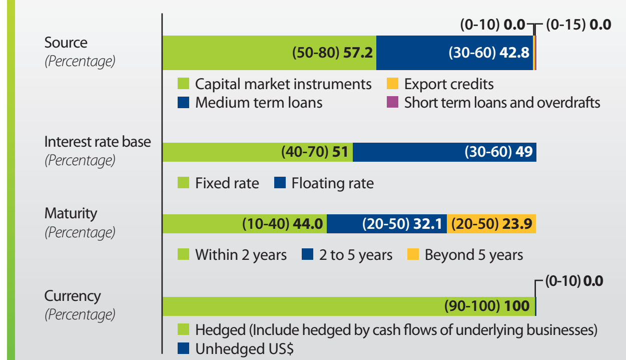
To control and diversify counterparty risks, the Group limits exposure to credit risk by placing deposits and transacting derivative instruments with financial institutions having acceptable investment grade credit ratings.

In accordance with Board policy, all derivative instruments with a counterparty are subject to a counterparty limit based on the counterparty's credit ratings. Credit exposure is estimated based on estimated fair market value and largest potential loss arising from these instruments using a "value-at-risk" concept, and monitored and controlled against respective counterparty limits. To further reduce risk, the Group applies set-off and netting arrangements across different instruments with the same counterparty.

PREFERRED FINANCING MODEL AND DEBT PROFILE

The Preferred Financing Model exemplifies the Company's prudent approach to debt management and helps ensure a well balanced debt portfolio.

(Preferred Financing Model) vs. **Actual debt profile** *As at 31 December 2011*



Deposits and short-term investments are also subject to separate counterparty limits based on credit ratings and/or their note issuing bank status in Hong Kong. To further control risk, there is limit on the length of time that a deposit or short-term investment can be maintained with a counterparty.

The Group actively monitors credit ratings and credit related changes of all its counterparties using such additional information as the counterparties' credit default swap levels, and will, based on these changes, adjust the counterparty limits accordingly.

In managing liquidity risk, the Group will maintain sufficient cash balance and undrawn committed banking facilities to provide forward coverage of at least 6 to 15 months of projected cash requirements. The Group also conducts regular stress testing of projected cash flow to identify and estimate potential shortfall, and would arrange new financings or take other appropriate actions if such stress tests reveal significant risk of material cash flow shortfall.

Credit Ratings

Throughout the year, the Company maintained strong investment grade ratings on par with the Hong Kong Special Administrative Region Government.

The Company's issuer and senior unsecured debt ratings as well as short-term rating were affirmed in June by Moody's at respectively "Aa1" and "P-1" with a stable outlook.

In August, the Company's issuer and short-term credit ratings were affirmed by Rating & Investment Inc. of Japan at respectively "AA+" and "a-1+", with a stable outlook.

This was followed in October by S&P's affirmation of the Company's long-term corporate credit and short-term ratings of respectively "AAA" and "A-1+" with a stable outlook.

Financing Capacity

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

Capital expenditure for Hong Kong railway projects comprises investment in and expenditures relating to new ownership projects, including the West Island Line, South Island Line (East) and the Kwun Tong Line Extension, as well as outlays for maintaining and upgrading the existing railway lines and station commercial facilities. Concession projects such as the Express Rail Link are generally funded by the Government.

Capital expenditure for Hong Kong property investment and development comprises mainly costs of enabling works for property development, fitting-out and renovation works of shopping centres. Expenditure for Mainland and overseas investments consists primarily of equity contribution for the upcoming Hangzhou Line 1 project, remaining capital expenditure for SZL4, and investment in the SZL4 Depot property development site.

Based on current programme, total net capital expenditure for the next three years from 2012 to 2014 (inclusive) is estimated at HK$32.5 billion for Hong Kong railway projects, HK$5.5 billion for Hong Kong property investment and development, and HK$7.5 billion for Mainland and overseas investments, for a total of HK$45.5 billion. Out of this total, it is estimated that HK$21.0 billion will be incurred in 2012, HK$12.3 billion in 2013, and HK$12.2 billion in 2014.

At the end of 2011, the Group maintained total cash, deposits and investment-grade liquid investments amounting to HK$19,074 million. This, together with future projected cash flow, is expected to be sufficient to cover the Group's projected funding requirement including debt refinancing and net capital expenditure well into 2012.

Credit ratings	Short-term ratings*	Long-term ratings*
Standard & Poor's	A-1+/A-1+	AAA/AAA
Moody's	-/P-1	Aa1/Aa1
Rating & Investment Information, Inc. (R&I)	a-1+	AA+

* Ratings for Hong Kong dollar/foreign currency denominated debts respectively