

Review of 2006 financial results

Profit and loss

Fare revenue from MTR Lines increased by 3.3% to HK\$5,911 million as a result of a 1.0% growth in patronage to 867 million and a 2.2% increase in average fare to HK\$6.82. The increase in average fare was due to the full-year effect of both changes in certain promotion programmes and the opening of DRL operations.

Fare revenue from the Airport Express increased by 9.1% to HK\$612 million due to a patronage increase of 12.8% to 9.6 million resulting from growth in air-passengers and the full-year effect of the opening of the AWE Station, partly offset by a 3.4% decline in average fare to HK\$63.85 attributable to the lower average fare for passengers travelling to and from the AWE Station.

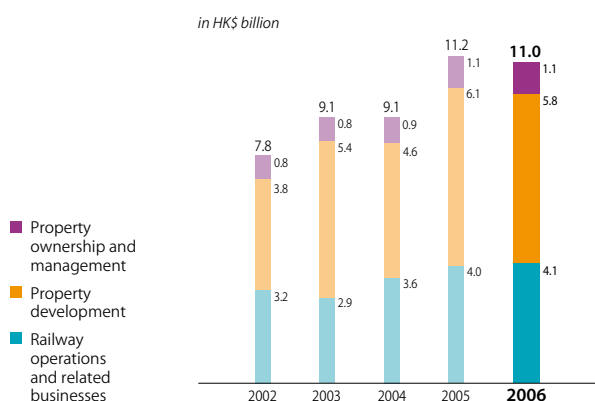
Non-fare revenues increased by 5.1% to HK\$3,018 million, comprising HK\$1,606 million from station commercial and other businesses and HK\$1,412 million from property ownership and management. In 2005, a one-off income was received from settlement of an early termination of a telecommunication contract. Excluding this and other minor non-recurring incomes received in 2006 relating to mobile network upgrading, non-fare revenue would have increased by 7.7%.

Income from station commercial and other businesses increased by 3.3%, attributable mainly to growth in advertising income and shop rental which rose by 4.7% and 13.7% respectively. This growth was supported by the strong economy and our introduction of new advertising formats as well as expansion of kiosk area from the station renovation programme. Ngong Ping 360, which opened in September 2006, also contributed HK\$64 million to revenue. Income growth in telecommunications was affected by the non-recurring income received in 2005 and the continuous cannibalisation and pricing pressure in the mobile phone market. Consultancy and other miscellaneous business revenues were steady.

With continued growth in the retail market and the addition of more retail space and property management contracts in the portfolio, income from property ownership and management increased by 7.3% to HK\$1,412 million. Rental income increased by 6.8% to HK\$1,263 million as a result of higher rental rates achieved on relet and renewal cases, increased turnover rent received and the full-year operation of The Lane as well as the opening of the Choi Hung Park and Ride and The Edge in 2006. Property management income increased by 12.0%, mainly attributable to the expansion of the management portfolio, including new additions such as The Arch, The Grandiose and Metro Town.

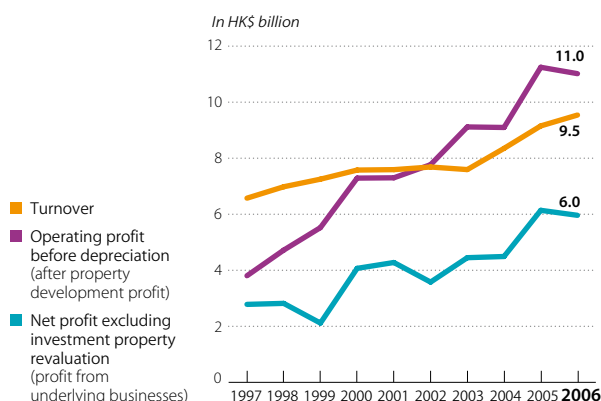
Operating profit contributions

Good overall results maintained despite slightly lower profit from property development.



Net results from underlying businesses

The lower development profit also affected net profit before investment property revaluation.



Staff costs and related expenses rose by 2.4% during the year, mainly due to annual salary increase. Operational rent and rates reduced by 29.3% owing to a one-off income from settlement with Government on ratable value assessment relating to the Tseung Kwan O Line, backdated to 2002 when it opened. Excluding this one-off item, operational rent and rates would have increased by 9.8%. Expenses related to station commercial and other businesses increased by 23.7%, in line with the growth of business activities, while property ownership and management expenses increased by 31.1%, mainly due to business expansion in Hong Kong and expenditures for Ginza Mall in Beijing. Project studies and business development expenses increased by HK\$125 million due to increased development activities in Hong Kong, the Mainland of China and Europe, as well as the pre-operating expenditures for Ngong Ping 360. Overall operating costs during the year increased by 7.1% to HK\$4,340 million.

Operating profit from railway and related businesses before depreciation therefore increased by 2.0% from HK\$5,101 million in 2005 to HK\$5,201 million in 2006. Operating margin was 54.5%, compared to 55.7% in 2005.

Property development profit in 2006 amounted to HK\$5,817 million compared to HK\$6,145 million in 2005, mainly comprising surplus proceeds from The Grandiose and Central Heights at Tseung Kwan O Station and Metro Town (Tiu Keng Leng Phase 1), recognition of deferred income from Coastal Skyline and Caribbean Coast at Tung Chung Station, Harbour Green at Olympic Station and Elements at Kowloon Station, as well as sharing-in-kind in respect of an additional floor area of 7,609 square metres at Elements at Kowloon Station.

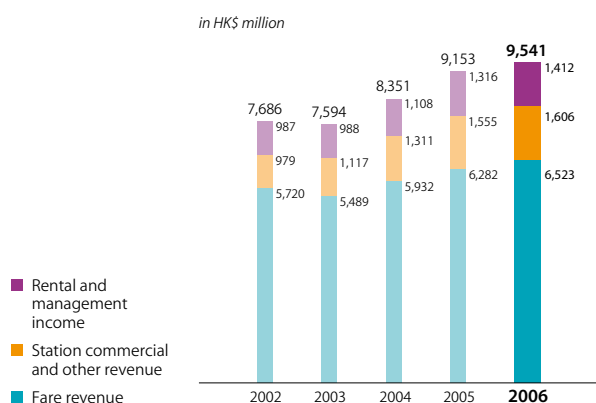
Operating profit before depreciation was HK\$11,018 million, a slight reduction of 2.0% from HK\$11,246 million in 2005. Depreciation charge for the year amounted to HK\$2,674 million. This represents a similar level as in 2005 after accounting for the addition of Ngong Ping 360 and other new assets, as well as the full year depreciation charge in 2006 for DRL and the AWE Station, which were offset by the termination of depreciation on certain assets which have been fully depreciated.

Net interest expense for 2006 amounted to HK\$1,398 million, an increase of 2.7% owing to the rise in interest rates and the expensing of interest costs relating to DRL and the AWE Station which are no longer capitalised. With higher market interest rates, the Company's average interest cost increased from 5.1% in 2005 to 5.5% in 2006, whilst interest cover reduced from 7.6 times in 2005 to 6.7 times in 2006. In compliance with the Hong Kong Accounting Standard ("HKAS") 40 on revaluation of investment properties, the increase in market value of our investment properties in 2006 of HK\$2,178 million pre-tax (HK\$1,797 million post-tax) was recognised in the profit and loss account. In 2005, an amount of HK\$2,800 million pre-tax (HK\$2,310 million post tax) was recognised in the profit and loss account.

The Company's share of net profit of OHL amounted to HK\$68 million, an increase of 70% from 2005. The Company's share of costs for bidding for the South Western Franchise in the United Kingdom, via a jointly controlled entity established with the joint venture partner, amounted to HK\$23 million. Tax expense comprising mainly deferred tax provision amounted to HK\$1,411 million. As a result, the net profit for the Group in 2006 declined by 8.3% to HK\$7,758 million, of which HK\$7,759 million was attributable to equity shareholders, a drop of 8.2% from 2005. Earnings per share correspondingly decreased from HK\$1.55 in 2005 to HK\$1.41 in 2006.

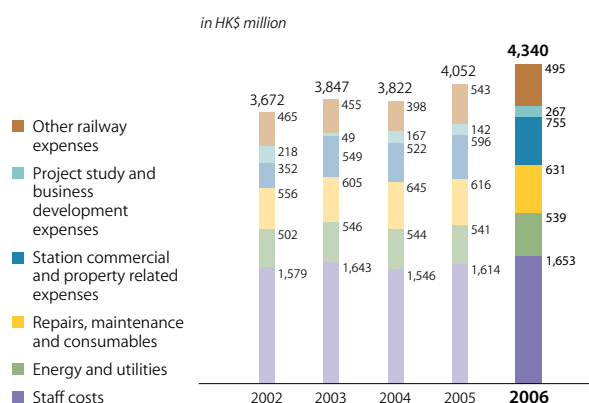
Turnover

Growth in revenue came across the board, supported by our expanding operations and a strong economy.



Operating expenses

Most cost items rose, largely reflecting the growth in our business activities.



Excluding investment property revaluation and the related deferred tax provision, the underlying profit for the Group was HK\$5,962 million with earnings per share of HK\$1.08, which were respectively 2.9% and 4.4% lower than 2005.

The Board has recommended a final dividend of HK\$0.28 per share, amounting to HK\$1,554 million in total, with a scrip dividend option offered 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. On 8 November 2006, FSI agreed that it will extend its commitment to receive its entitlement to dividends in the form of shares (if a scrip dividend is offered by the Company) to the extent necessary to ensure that a maximum of 50% of the Company's total dividend will be paid in cash in respect of each of the three financial years ending 31 December 2009.

Balance sheet

The Group's balance sheet remains strong, with the bulk of assets invested in the railway system. Total fixed assets increased from HK\$103,275 million in 2005 to HK\$106,943 million as at 31 December 2006, mainly attributable to a surplus from investment property revaluation, the receipt of retail space (The Edge) at the Grandiose in Tseung Kwan O and 7,609 square metres gross of Elements at Kowloon Station as well as the capitalisation of Ngong Ping 360 upon commissioning in September 2006.

Railway construction in progress decreased from HK\$1,006 million in 2005 to HK\$232 million as at 31 December 2006, mainly resulting from transfer-out of the Ngong Ping 360 project costs to fixed assets upon completion, being partly offset by additional capital expenditures on the SkyPlaza Platform at the Airport and the Tseung Kwan O South Station projects.

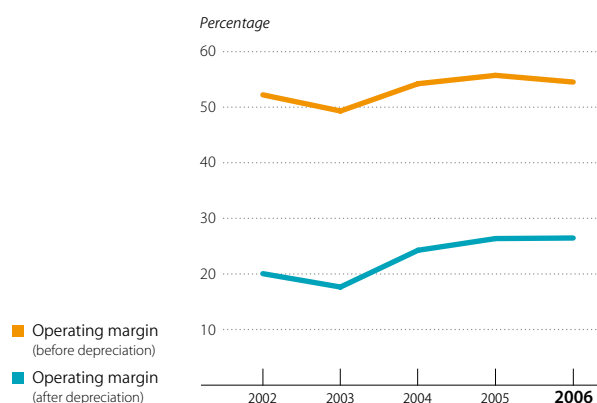
Property development in progress represents costs incurred in property development sites less reimbursement already received from developers. Property development in progress as at 31 December 2006 increased to HK\$3,297 million from HK\$2,756 million in 2005, mainly due to the capitalisation of interest in respect of an interest-free loan provided to the property developer of Tsung Kwan O Area 86 Package Two development, partly offset by reimbursement, received from developer of the same project, of up-front costs expended.

Properties held for sale increased to HK\$2,018 million from HK\$1,311 million in 2005 comprising mainly unsold residential units at the Grandiose, Central Heights and Metro Town in Tseung Kwan O, and at The Arch in Kowloon Station.

Derivative financial assets and liabilities, which represent the fair value of derivative financial instruments as required by HKAS 39, were recorded at HK\$195 million and HK\$515 million respectively as at 31 December 2006 as compared to HK\$234 million and HK\$307 million respectively in 2005. The movements were mainly due to higher US interest rates and stronger Hong Kong dollar forward exchange rates during the period, causing a decline in the value of the Group's interest rate and currency fair value hedges.

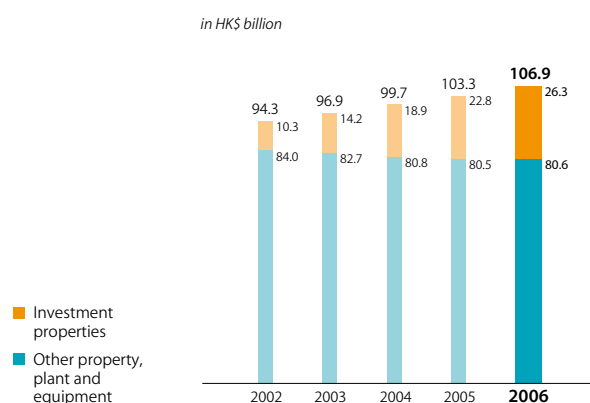
Operating margin

Operating margin has shown a steady improvement since 2003.



Fixed assets growth

Surplus on property revaluation, capitalisation of Ngong Ping 360, as well as receipt of The Edge and part of Elements led to the growth in fixed assets.



Debtors, deposits and payments in advance decreased significantly to HK\$1,894 million from HK\$3,095 million in 2005 as a result of collection of receivable from purchasers of residential units which had been pre-sold.

The interest-free loan of HK\$4,000 million lent to the property developer of Tseung Kwan O Area 86 Package Two development was recognised on the balance sheet at its fair value of HK\$3,232 million at inception. As at the end of the year, this loan receivable carried a balance of HK\$3,355 million after recognition of capitalised interest of HK\$123 million accrued during the year.

The carrying amount of total debt outstanding at year end was HK\$28,152 million. Excluding the mark-to-market and hedge accounting effects, total debt outstanding was HK\$28,768 million, an increase of HK\$94 million compared with 2005. Total debt drawn down during the year amounted to HK\$8,428 million, which was primarily used for refinancing purposes.

Deferred income decreased from HK\$3,584 million in 2005 to HK\$1,682 million following profit recognition at Tung Chung, Kowloon and Olympic station development packages, in accordance with the progress of property construction and pre-sales activities.

Deferred tax liabilities increased from HK\$8,011 million to HK\$9,453 million, mainly attributable to the tax effect on profit for the year, including provision on property revaluation, at the standard Hong Kong Profits Tax rate of 17.5%.

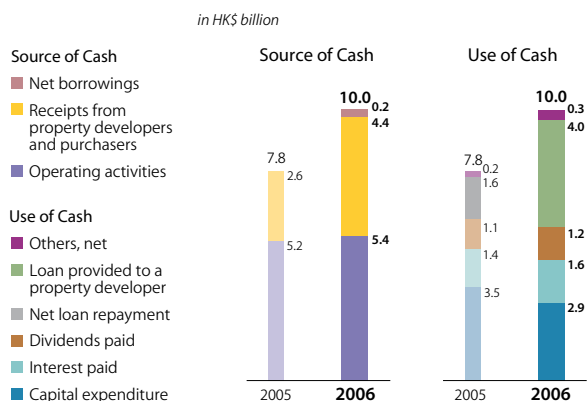
Share capital, share premium and capital reserve increased by HK\$1,189 million to HK\$38,639 million at year end due to shares issued for scrip dividend and share options exercised. Together with increases in fixed asset revaluation and other reserves of HK\$253 million and retained earnings net of dividends of HK\$5,450 million, total equity attributable to equity shareholders increased to HK\$76,767 million from HK\$69,875 million as at 31 December 2005. As a result, the Group's debt-to-equity ratio improved from 40.4% to 36.7% at 2006 year end and net debt-to-equity ratio from 39.9% to 36.3%.

Cash flow

Net cash inflow generated from railway and related activities increased from HK\$5,189 million in 2005 to HK\$5,400 million for the year, while cash receipts from developers and purchasers in respect of property development projects also increased from HK\$2,610 million in the previous year to HK\$4,400 million. Outflows for capital project payments, interest expenses, changes in working capital and dividend payments amounted to HK\$5,934 million before a one-off interest-free loan of HK\$4,000 million provided to a property developer, as compared to HK\$5,993 million for the previous year. Hence, excluding the one-off interest-free loan, the Company would have recorded a net cash inflow of HK\$3,866 million compared to HK\$1,806 million in 2005. After this one-off loan advance, there was a cash deficit of HK\$134 million which was financed by an increase in debt of HK\$94 million and a drawdown of cash balances of HK\$40 million.

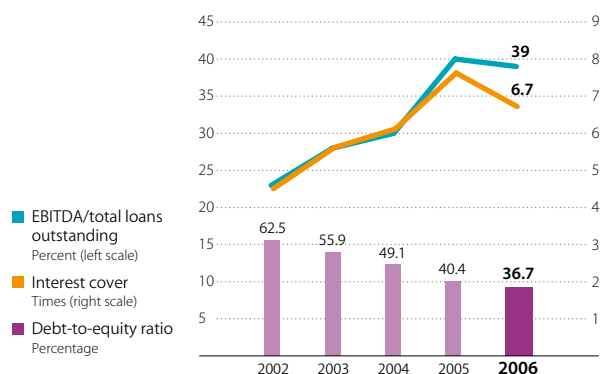
Cash utilisation

2006 saw a minor net cash outflow, against an inflow in 2005, as the Company invested in new projects and provided a loan to a developer.



Debt servicing capability

Total debt outstanding reduced slightly in 2006, with MTR Corporation's debt service ability remained strong and the debt-to-equity ratio improved.



Financing activities

New financings

During the first half of 2006, Hong Kong dollar interest rates rose in tandem with US rates as the Federal Reserve continued to pursue a tighter monetary policy by raising the Fed Funds target rate. Interest rates stabilised when the Fed Funds rate reached 5.25% and the Federal Reserve signalled a temporary halt to the tightening policy. During the year, the Hong Kong dollar market continued to be flooded with liquidity, attracting strong capital inflows from the buoyant stock market and IPO activities. As a result, Hong Kong dollar interest rates remained consistently below US rates during the year.

In 2006, the Group continued to focus our fund raising activities in the Hong Kong dollar market to take advantage of the excess liquidity and lower interest rates. In February and November, the Group successfully launched two separate fixed rate medium term note (MTN) issues via private placement, a HK\$500 million 2-year note and a HK\$1.0 billion 3-year note with respective coupon rates of 4.3% and 4.15%.

The excess liquidity in the market also helped drive down credit spreads in the banking market further, enabling the Group to enter into a number of bilateral loan facilities on attractive terms. During the year, the Group arranged a total of HK\$2.6 billion in bilateral bank loans, comprising HK\$1.5 billion in 5 years maturity and HK\$1.1 billion in 7 years maturity. This, together with the HK\$1.5 billion MTNs issued, helped raise a total of HK\$4.1 billion of new financings for the Group in the year.

As at the end of 2006, the Group had total undrawn committed facilities of HK\$5.7 billion, which together with cash on hand and projected positive operating cash flow during 2007 are expected to provide sufficient coverage for anticipated funding needs well through 2007.

Cost of borrowing

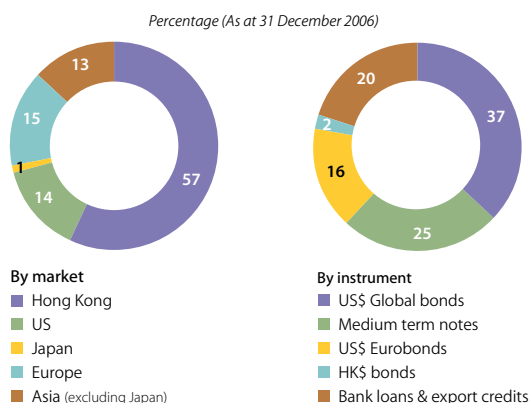
The Group's exposure to interest rate risk is well contained due to our conservative mix of fixed and floating rate debts, and ability to secure attractive fixed rate financings. As a result, despite the significant increase in short-term rates in the first half, average borrowing cost for the year rose to 5.5% from 5.1% in 2005. Due to the higher average rate and increased borrowings, gross interest expense for 2006 increased by HK\$49 million to HK\$1,524 million.

Risk management

We continued to conduct our financing and hedging activities in accordance with our well-established Preferred Financing Model, which seeks to diversify risks by specifying 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. In doing so, the Company was able to maintain a well diversified debt portfolio with adequate forward coverage of its future funding requirement.

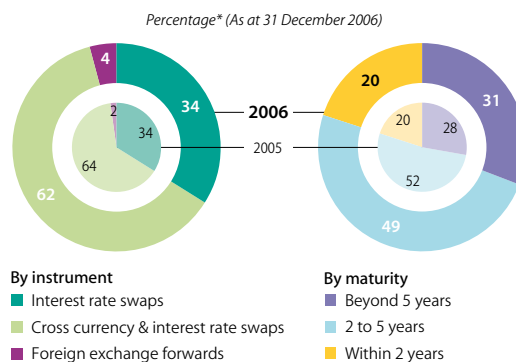
Sources of borrowing

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



Use of interest rate and currency risk hedging products

The Company is an active user of derivative financial instruments, and has a strict policy of limiting their use for hedging purposes only.



* Calculated based on nominal value

The Company remains an active corporate user of derivative financial instruments to manage our debt portfolio. The policy of the Company stipulates that these instruments can only be used for hedging purposes to reduce exposure to interest rate and currency risks, and not for speculation or trading purposes. To monitor and control counterparty risk exposure, the policy requires all counterparties to have a minimum credit rating of A-/A3, and that limits be assigned to these counterparties in accordance to their credit ratings. In addition, the Company adopts a risk monitoring framework based on the widely accepted “value-at-risk” methodology, and an “expected loss” concept to quantify and monitor these exposures.

Credit ratings

The Company was the first Hong Kong corporate entity to obtain internationally recognised credit ratings and has since maintained strong ratings on par with the Hong Kong SAR Government based on our credit fundamentals, prudent financial management and continuous Government support.

In May, Moody’s upgraded the Company’s long-term foreign currency issuer rating from A1 to Aa3 with a stable outlook, following a review of corporate ratings throughout the region based on its revised rating methodology for “Foreign-Currency Ceilings”. At the same time, Moody’s reaffirmed the Company’s short-term issuer rating at P-1 and long-term local currency issuer/foreign currency debt ratings at Aa3, with a stable outlook. In July, Moody’s changed the rating outlook for the Company from stable to positive.

In July, Standard & Poor’s raised the Company’s long-term local/foreign currency ratings from AA- to AA and reaffirmed our short-term local/foreign currency ratings at A-1+ with a stable outlook.

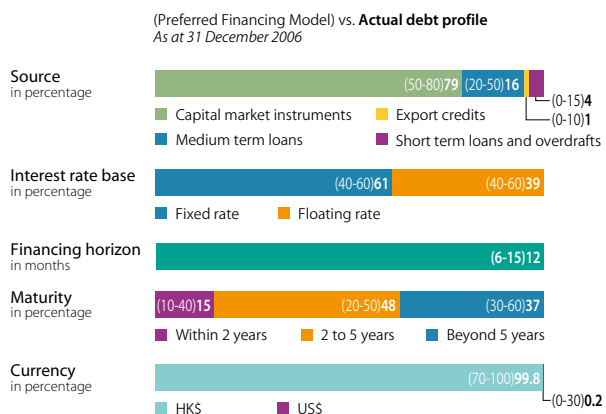
Credit ratings	Short-term ratings*	Long-term ratings*
Standard & Poor’s	A-1+/A-1+	AA/AA
Moody’s	-/P-1	Aa3/Aa3
Rating and investment Information Inc. (R&I)	a•1+/-	AA/AA

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

In August, R&I also upgraded the Company’s long-term foreign currency rating from AA- to AA and reaffirmed our short/long-term local currency ratings at a•1+/AA with a stable outlook.

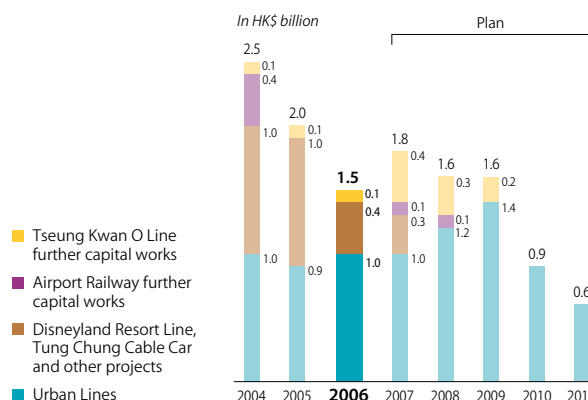
Preferred financing model and debt profile

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



Investment in new railway lines and existing network in Hong Kong

Projected capital expenditures between 2007–2009, based on existing network and committed projects, are estimated at HK\$5 billion.



Financial planning

We continued to use our comprehensive long-term financial planning model based on well-established methodologies to plan our railway operations and evaluate new projects and investments. The 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 also carefully review all key assumptions used in the model, and conduct sensitivity analyses on key variables, taking into account present business and economic conditions, and future likely changes. To manage our cost of capital effectively, detailed assessment of our funding requirement and capital structure is conducted on a regular basis.

Financing capacity

The Company's current projected capital expenditure programme comprises three parts – railway and property projects in Hong Kong, and overseas investment. Capital expenditure for railway projects in Hong Kong consists mainly of capital outlays for sustaining and upgrading existing lines as well

as investment in new railway projects, whilst for property development, it comprises mainly the costs of fit-out works for Elements, property development enabling works for Tseung Kwan O South Station and common infrastructure works for Area 86 development sites. For overseas investments, it consists mainly of capital expenditure for Shenzhen Metro Line 4 construction and the related property development as well as equity investment for BJL4. Based on current programmes, total capital expenditures for the three years between 2007 and 2009 are estimated to be approximately HK\$5 billion for railway projects, HK\$1.4 billion for property investment in Hong Kong and HK\$6.4 billion for overseas investments, resulting in a total of HK\$12.8 billion. Of the HK\$6.4 billion requirement for overseas investment, a RMB3.6 billion project loan for the Shenzhen Metro Line 4 project has already been secured. In light of our strong financial position and these modest commitments, the Group expects to have sufficient financing capacity to fund other new investment opportunities in Hong Kong such as West Island Line, the South Island Line (East) and (West), and overseas.