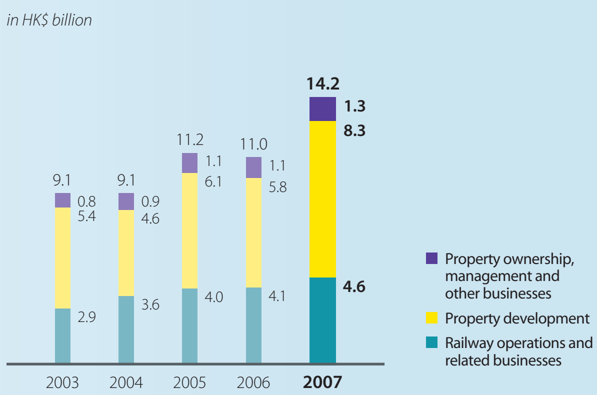
Financial Review

The Company's 2007 financial statements have incorporated the operating results of the Rail Merger with effect from 2 December 2007

Operating Profit Contributions

Steady growths were maintained in all segments with significant profit increase from property development.



Review of 2007 Financial Results

The Company's 2007 financial statements have recognised the Rail Merger which became effective on the Appointed Day of 2 December 2007, together with the post-merger operating results from 2 December to the year end (Rail Merger effect). In the profit and loss account, the impacts were primarily reflected as increases in operating profits, amortisation charge, interest charge and provision for merger related expenses. On the balance sheet, the Rail Merger increased total assets mainly from the recognition of the Service Concession, which includes the capitalised amount of total annual fixed concession payments of HK$750 million per year, and the property package acquired, as well as increased total liabilities by the additional borrowings, obligations under the Service Concession and other liabilities arising from the transaction. Payment for the Rail Merger was mainly financed by additional borrowings. Details of the Rail Merger impacts to the 2007 financial results are included in the following discussion.

Profit and Loss

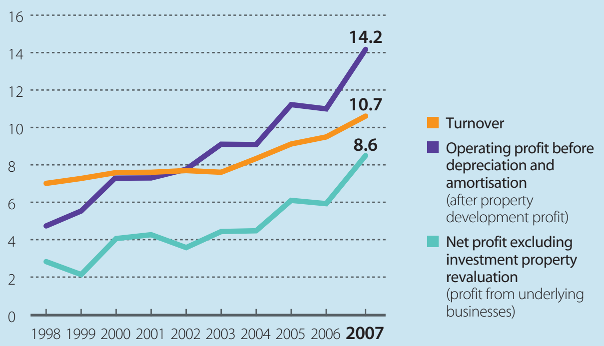
Total revenues for 2007 increased by 12.0% to HK$10,690 million driven by the strong Hong Kong economy, continued expansion of our businesses and the Rail Merger effect.

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, which was mainly due to the fare reduction implemented on the Appointed Day as well as the lower average fare on KCR Lines. 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 mainly due to the one-off mobile network upgrade income recognised in 2006, which was not repeated in 2007, and the decrease in the Company's revenue sharing as a result of intense price competition and cannibalisation by 3G mobile services. Consultancy income decreased slightly by 3.0% to HK$193 million mainly due to programme delays of some projects caused by the changing requirements of our customers. Excluding the Rail Merger effect, which contributed HK$125 million, revenues from station commercial and rail related businesses would have increased by 4.8% in 2007.

Net Results from Underlying Businesses

The increase in net profit was brought by sustained rise in turnover and significant increase in development profit.



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 strong growth of 23.9%. Excluding the Rail Merger effect, the growth in property rental and management income would have been 22.3%.

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. Excluding the Rail Merger effect, total operating costs would have increased by 4.4%. 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.

Profit from Underlying Businesses Increased 43.8% to **HK$8,571 Million**

Strong Property Development Profit at **HK$8,304 Million**

Net Profit of **HK$15,182 Million**

Turnover Increased 12% to **HK$10,690 Million**

Net Cash Inflow of **HK$6,122 Million** before Rail Merger Payments

Net Assets Increased 18.6% to **HK$91,037 Million**

HK$10 Billion Syndicated Loan Facility Arranged on Favourable Terms

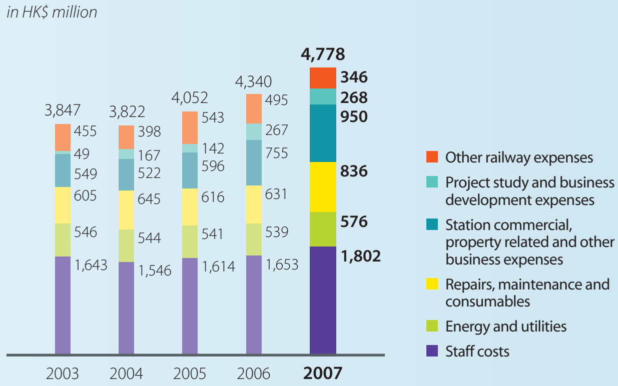
Credit Ratings Affirmed after Rail Merger Bill **and Upgraded** along with Hong Kong SAR

Turnover

Revenue increased across the board due to the Rail Merger, the expanding operations and a strong economy.

Operating Expenses

The cost increases were in line with business expansions including 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. It is estimated that the Rail Merger effect contributed approximately HK$284 million to such operating profit. Operating margin increased from 54.5% in 2006 to 55.3%.

With the continued rise in property prices, the number of property projects completed in the year and profit recognition for Le Point (where costs relating to that project were recognised in 2006), property development profit for 2007 increased significantly to HK$8,304 million from HK$5,817 million in 2006. Income from surplus proceeds amounted to HK$7,077 million mainly relating to Le Point at Tiu Keng Leng Station and to a lesser extent, Harbour Green at Olympic Station and Caribbean Coast at Tung Chung Station. Deferred income recognised amounted to HK$1,224 million mainly from Coastal Skyline and Caribbean Coast at Tung Chung Station and the fit-out works for Elements at Kowloon Station.

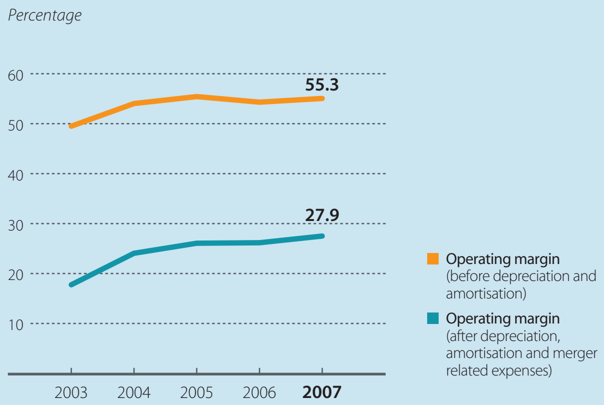
Operating profit before depreciation and amortisation therefore increased 29.0% to HK$14,216 million. Depreciation and amortisation charges for 2007 increased by 2.4% to HK$2,739 million due to the additional amortisation charge on Service Concession assets related to the Rail Merger as well as the full year depreciation charge on Ngong Ping 360 and other assets added to the network. After deducting merger related expenses of HK$193 million, operating profit before interest and finance charges increased by 35.2% to HK$11,284 million.

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. The post-tax valuation gain on investment properties was HK$6,609 million.

As part of the Rail Merger, the Company acquired certain property holding and other subsidiaries from KCRC. This combined with the takeover of operations of Ngong Ping 360 resulted in a net gain of HK$187 million, mainly due to increases in market value, as at the Appointed Day, of investment properties held by those subsidiaries in excess of their purchase considerations. 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 based on the current standard Hong Kong Profits Tax rate of 17.5%. 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.

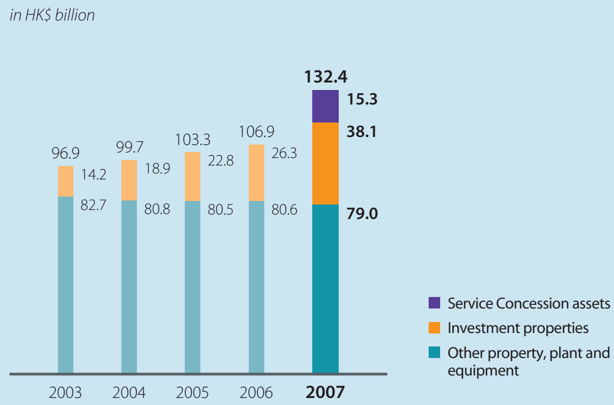
Operating Margin

Operating margin has improved steadily over the years.



Fixed Assets Growth

Significant surplus on property revaluation and additions of Service Concession assets and investment properties after the Rail Merger accounted for the growth in fixed assets.



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.

In view of the good financial performance 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 2007, representing an increase of HK$0.03 or 7.1% compared to 2006. 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. 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 2007 with an 18.6% increase in net assets from HK$76,786 million as at 31 December 2006 to HK$91,037 million as at 31 December 2007.

Total fixed assets increased from HK$106,943 million in 2006 to HK$132,417 million as at 31 December 2007 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 as at 31 December 2007 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 at 31 December 2007 as a result of the additional construction works for 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.

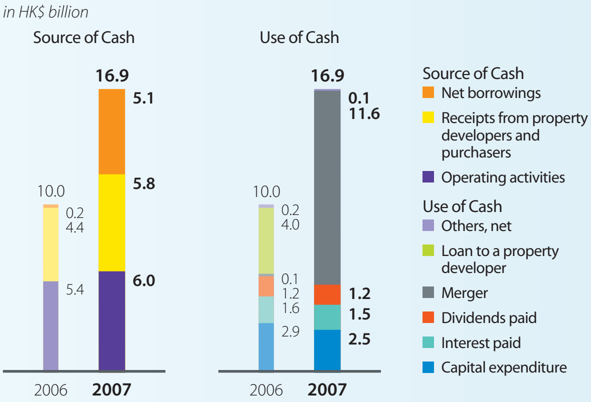
Property development in progress increased significantly from HK$3,297 million in 2006 to HK$9,066 million as at 31 December 2007, mainly due to the acquisition costs of property development rights in the Rail Merger. Properties held for sale as at 31 December 2007 amounted to HK$756 million, comprising 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

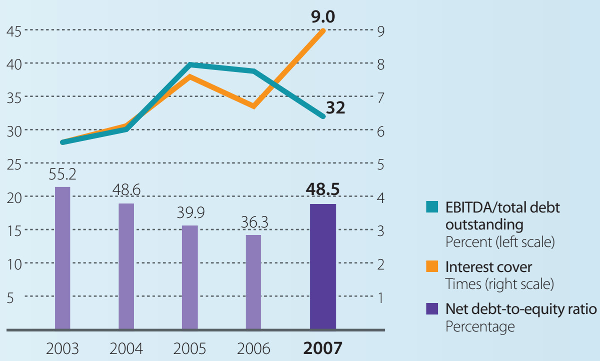
Cash Utilisation

Cash outflows for Rail Merger in 2007 was met by surplus from operations and additional borrowings.



Debt Servicing Capability

Total debt outstanding including obligations under Service Concession increased in 2007 due to the Rail Merger with a corresponding increase in gearing.



at HK$273 million and HK$192 million respectively as at 31 December 2007 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, resulting in an increase in "mark-to-market" value of the Group's interest rate and currency fair value hedges.

Debtors, deposits and payments in advance increased significantly from HK$1,894 million in 2006 to HK$5,167 million as at 31 December 2007 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 as at 31 December 2007 mainly due to increased borrowing to fund the initial payments for the Rail Merger.

As at 31 December 2007, the amount due to KCRC 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 to KCRC. In recognising the discounted present value of the total fixed annual payments as a Service Concession asset, an equivalent amount has been taken into account as obligations under the Service Concession, the balance of which at the year end was HK$10,685 million.

Creditors, accrued charges and provisions as at the end of 2007 amounted to HK$5,412 million as compared to HK$3,639 million in 2006. The increase was 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 from HK$1,682 million in 2006 to HK$515 million as at 31 December 2007, 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, as well as income to be recognised in connection with the lease out and lease back transaction on certain passenger cars.

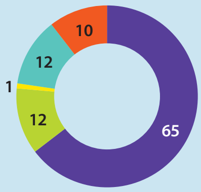
With the recognition of tax on the profit for the year, including deferred tax provision for property revaluation, deferred tax liabilities increased from HK$9,453 million to HK$12,574 million.

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 from HK$76,767 million in 2006 to HK$91,014 million as at 31 December 2007. Including the

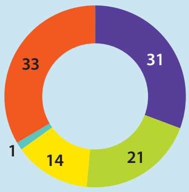
Sources of Borrowing

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 2007)



By market
- Hong Kong
- US
- Japan
- Europe
- Asia (excluding Japan)

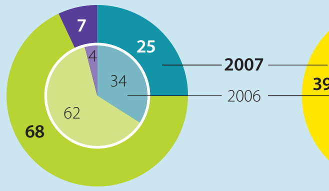


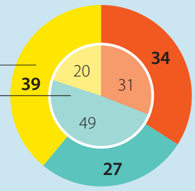
By instrument
- US$ Global bonds
- Medium term notes
- US$ Eurobonds
- HK$ bonds
- Bank loans & export credits

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.

Percentage (As at 31 December 2007)*





By instrument
- Interest rate swaps
- Cross currency & interest rate swaps
- Foreign exchange forwards

By maturity
- Beyond 5 years
- 2 to 5 years
- Within 2 years

** Calculated based on nominal value*

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

Net cash inflow generated from railway and related activities increased from HK$5,387 million in 2006 to HK$5,965 million for the year, while cash receipts from developers and purchasers in respect of property development projects also increased from HK$4,400 million in the previous year to HK$5,824 million. Outflows for capital project payments, interest expenses, working capital and dividend payments amounted to HK$5,667 million, as compared to HK$5,925 million for the previous year. Hence, before upfront payments for the Rail Merger, the Company had recorded a net cash inflow of HK$6,122 million compared to HK$3,862 million in 2006. 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

In 2007, Hong Kong continued to benefit from robust economic growth and a buoyant stock market, and saw continued significant capital flows into the local banking system. In the first eight months of the year, the U.S. Federal Reserve (the Fed) maintained the Fed Funds target rate at 5.25%, but throughout this period Hong Kong interest rates gradually rose on the back of significant funding demand for financing IPO activities, narrowing the differential with U.S. rates. However, the Fed began to aggressively cut the Fed Funds rate in September due to the potential impact of the subprime mortgage crisis. These actions, comprising rate cuts both at and in-between Federal Open Market Committee meetings, brought the Fed funds rate down from 5.25% to 2.25% as of 18 March 2008. These aggressive cuts, together with a slowdown in IPO activities and lacklustre stock market performance closer to the year end, caused Hong Kong rates to decline after reaching their peaks in October.

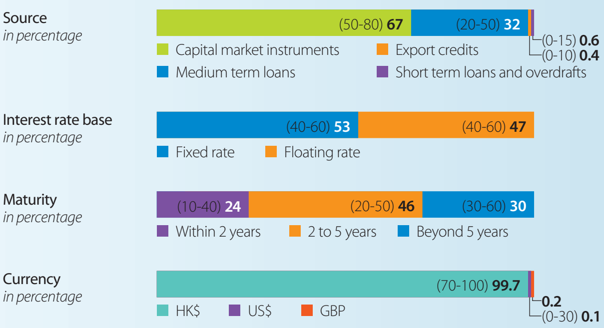
The Group's main financing activity was a HK$10 billion syndicated loan facility signed in October 2007 with a group of 19 major banks from Hong Kong, Mainland of China, Japan, Europe and the U.S., to meet our general corporate funding requirements, including partial settlement of the upfront payment 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. With strong positive operating cash

Preferred Financing Model and Debt Profile

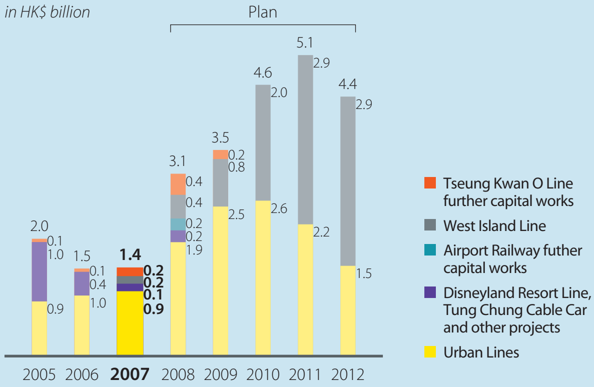
The Preferred Financing Model exemplifies the Company's prudent approach to debt management and helps ensure a well balanced debt portfolio.

(Preferred Financing Model) vs. **Actual debt profile** *As at 31 December 2007*



Investment in New Railway Lines and Existing Network in Hong Kong

Projected capital expenditures between 2008-2010, based on existing network and committed projects, are estimated at HK$11.2 billion.



flows projected for 2008 and 2009, these undrawn facilities would be used mainly for contingency purposes or to meet unexpected demands, if any.

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. However, gross interest and finance charges (before interest income and impact from derivative financial instruments) decreased to HK$1,580 million in 2007 from HK$1,685 million in 2006; the amount in 2007 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 guides our financing and hedging activities 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. With this disciplined and systematic approach, the Group was able to maintain a well diversified debt portfolio with adequate forward coverage of our future funding requirements.

The Group remains an active corporate user of derivative financial instruments to manage our debt portfolio based on the policy that such 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, Company policy requires all counterparties to have a minimum credit rating of A-/A3, and that exposure limits be assigned 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" methodology, and an "expected loss" concept to further quantify and monitor those 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 a par with the Hong Kong SAR Government based on our strong credit fundamentals, prudent financial management and continuous Government support.

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 Hong Kong SAR Government's Aa3 rating on review for possible upgrade. Following the passage of the primary legislation for the Rail Merger Bill by LegCo on 8 June 2007, Moody's on 16 July

2007 affirmed the Company's current ratings of Aa3 whilst continuing with the upgrade review process opining that the Company's sound credit standing would remain after the merger. The Company's ratings were subsequently upgraded to Aa2 with a stable outlook on 26 July 2007, following the rating agency's decision to upgrade the ratings of the Hong Kong SAR Government to Aa2.

Also on 16 July 2007, Standard & Poor's affirmed the Company's local and foreign currency long-term credit ratings at AA with a stable outlook and its A-1+ short-term corporate credit rating after considering the terms of the merger transaction and the strong support from the Government. Subsequently on 26 July 2007, the rating agency revised the outlook of the Company's AA ratings to positive from stable, in line with its revision of the outlook on the Hong Kong SAR's sovereign rating.

Credit ratings	Short-term ratings*	Long-term ratings*
Standard & Poor's	A-1+/A-1+	AA/AA
Moody's	–/P-1	Aa2/Aa2
Rating and Investment Information, Inc.	a • 1+/–	AA/AA

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

On 2 July 2007, Rating & Investment Information, Inc. of Japan affirmed the Company's foreign currency and Hong Kong dollar issuer ratings at AA with a stable outlook and short-term rating at a • 1+, citing the content of the Rail Merger as being reasonable to the Company. Subsequently, on 10 October 2007, the rating agency announced it had revised the Company's ratings outlook to positive whilst affirming its foreign currency and Hong Kong dollar issuer ratings at AA and short-term rating at a • 1+.

Financial Planning

We continued to use our comprehensive long-term financial planning model, which is based on well-established methodologies, to plan our railway operations and to 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 regularly and conduct sensitivity analyses taking into account present business and economic conditions as well as different scenarios in the future. To manage our cost of capital effectively, detailed assessment of our funding requirements and capital structure is conducted on a regular basis.

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. Capital expenditure for railway projects in Hong Kong consists mainly of investment in new railway projects, such as the West Island Line and the new station at LOHAS Park, and capital outlays for sustaining and upgrading the existing railway. For property projects, it comprises mainly the remaining fit-out works for Elements, fit-out works for the Tseung Kwan O Area 56 retail shells, and common infrastructure works for Area 86 development sites. For overseas investments, it consists mainly of capital expenditure for Shenzhen Metro Line 4 and further equity injections into Beijing Metro Line 4 public-private-partnership in the Mainland of China. 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.