Management Discussion and Analysis

(Financial figures are expressed in Hong Kong dollars)

OVERALL PERFORMANCE

The Group recorded a profit attributable to shareholders of $593 million for the year, compared with $740 million for 2001. The 20 per cent drop in profit was mainly attributable to the continued decline in stock market activities and low level of interest rates, which have caused a significant drop in income from sale of information, clearing and settlement fees and net interest income.

Income

Total income (including share of profits less losses of associated companies) for the year decreased by 9 per cent to $1,814 million (2001: $1,998 million).

The slow growth in the global economy, decline in consumer confidence, the accounting and corporate governance scandals affecting major corporations in the US, and the risk of war against Iraq kept investors away from the market in 2002. Closer to home, prolonged high unemployment, deflation and decline in property prices in Hong Kong have caused investor sentiment to deteriorate further, leading to a 18 per cent drop in the average daily turnover on the Stock Exchange to $6.7 billion in 2002 (2001: $8.2 billion). Although the average daily number of derivatives contracts traded on the Futures Exchange increased by 10 per cent, the decline in cash market activities and the 8 per cent reduction in the average daily number of stock options contracts traded have caused total trading fees, transaction levy and trading tariff to drop by 6 per cent to $332 million (2001: $351 million).

Despite the poor market conditions, 60 new companies joined the Main Board and 57 the Growth Enterprise Market (GEM) during the year, raising $52 billion of new capital. Listing fee income rose by 16 per cent to $320 million (2001: $275 million), as a result of higher number of listed securities and new listings of derivatives warrants. As at 31 December 2002, there were 812 companies listed on the Main Board and 166 on GEM (31 December 2001: 756 and 111 respectively).

In line with the 18 per cent decline in cash market activities, clearing and settlement fee income dropped by 15 per cent to $181 million (2001: $214 million). Depository, custody and nominee services fee income also fell by 7 per cent to $211 million (2001: $228 million) mainly due to lower scrip fee income for the year. Similarly, income from sale of information declined by 13 per cent to $294 million (2001: $337 million) as the demand for stock information decreased.

Investment income decreased by 31 per cent to $285 million (2001: $414 million), primarily due to a decline of 32 per cent in net interest income to $261 million (2001: $382 million), as the full-year impact of the successive interest rate cuts in 2001 was felt which led to mark-to-market and realised losses on our investment portfolio. Interest rates fell further in the fourth quarter of 2002 as Hong Kong followed suit after the US Federal Reserve reduced the Fed Funds Rate to a 41-year low. During the two years under review, the average 6-month Hong Kong Exchange

Fund Bill rate dropped from 3.41 per cent in 2001 to 1.70 per cent in 2002, and the average 90-day US Treasury Bill rate declined from 3.47 per cent to 1.62 per cent.

For the year ended 31 December 2002, the Group achieved a positive return on investments of 3.10 per cent (2001: 5.09 per cent). The portfolio recorded a spread of 140 basis points above the 6-month Hong Kong Exchange Fund Bill yield (2001: 168 basis points).

The average amount of funds available for investment shrank by 1 per cent to $9.1 billion, primarily due to a drop in margin funds received as margin requirements for various derivative products were reduced in line with volatility movements during the year. As at 31 December 2002, 44 per cent of the funds were invested in cash or bank deposits, 55 per cent in high-grade bonds with an average credit rating of Aa2, and 1 per cent in global equities.

Operating Expenses

Total operating expenses decreased by 1 per cent to $1,164 million (2001: $1,176 million).

Staff costs and related expenses were further reduced by $35 million to $493 million (2001: $528 million), principally due to a 7 per cent cut in salary and benefit costs.

Due to the Group's commitment to constantly enhance the capability and resilience of its trading and settlement systems, information technology and computer maintenance expenses rose by 14 per cent from $231 million to $263 million, mainly attributable to expenditures incurred on the upgraded Central Clearing and Settlement System (CCASS/3) during the year.

Legal and professional fees for the year decreased by 36 per cent from $62 million to $39 million, primarily owing to professional fees incurred for several one-off consulting projects in 2001.

Depreciation and amortisation costs increased by 7 per cent to $163 million (2001: $153 million), mostly due to the additional depreciation charge arising from the rollout of the first and second phases of CCASS/3 during 2002.

Other operating expenses rose by 4 per cent from $87 million to $91 million largely on account of restructuring costs incurred.

Taxation

The Group's taxation charge in 2002 declined by 31 per cent to $57 million (2001: $82 million), predominantly caused by the lower profit reported for the year.

Liquidity, Financial Resources, Gearing and Capital Commitments

Working capital increased by 4 per cent to $4,207 million at 31 December 2002 (2001: $4,037 million) mainly due to current year profit retained. Bank balances and time deposits of corporate funds fell by $615 million primarily due to the settlement of other payables and accruals.

Although the Group has consistently been in a very liquid position, credit facilities have nevertheless been put in place for contingency purposes. As at 31 December 2002, the Group's total available credit facilities amounted to $2,763 million (2001: $2,875 million), of which $1,500 million were repurchase facilities to augment the liquidity of the margin funds and $1,100 million were for meeting obligations of HKSCC in the Central Clearing and Settlement System (CCASS) in circumstances where CCASS Participants default on their payment obligations. Borrowings of the Group have been very rare and, if required, are mostly event driven, with little seasonality. As at 31 December 2002, the only facility drawn down was a fixed rate bank loan of SGD11 million (equivalent to HK$49 million) with a maturity of less than one year which was used for the purpose of hedging the currency exposure of the Group's investment in Singapore (2001: SGD11 million, equivalent to HK$46 million). The loan will be renewed annually.

As at 31 December 2002, the Group's gearing ratio, measured on the basis of total borrowings as a percentage of total shareholders' equity, was less than 1 per cent (2001: less than 1 per cent).

The Group's capital expenditure commitments, largely in respect of its ongoing investments in facilities and technology, amounted to $94 million as at 31 December 2002 (2001: $317 million). The Group has adequate financial resources to fund its commitments on capital expenditures from its existing cash resources and cash flows generated from its operations.

As at 31 December 2002, 99.8 per cent of the Group's cash and cash equivalents (comprise cash on hand, bank balances and time deposits within three months of maturity when acquired) were denominated in Hong Kong dollars (HKD) and United States dollars (USD).

Charges on Assets

As at 31 December 2001, the Group had a $10 million overdraft facility with a bank in Hong Kong, which was secured by a pledge of the Group's time deposits of an equivalent amount at that bank. This overdraft facility was not utilised and was terminated in 2002. The Group did not have any charges on assets as at 31 December 2002.

Significant Investments Held and Material Acquisitions and Disposals of Subsidiaries

The Group has been holding 1 per cent (10 million shares) of the issued ordinary share capital of Singapore Exchange Limited since November 2000.

On 2 April 2002, the Group acquired 3.6 million shares (14.47 per cent as at 31 December 2002) of the issued ordinary share capital of BondsInAsia Limited, an unlisted company incorporated in Hong Kong which provides an electronic trading platform for bond markets in Asia.

On 15 May 2002, the Group and Wilco International Limited, a wholly-owned subsidiary of Automatic Data Processing, Inc., formed a new joint venture, Wilco International Processing Services Limited, to provide Brokers' Electronic Support Services to Stock Exchange Participants.

On 31 May 2002, the share registration operations of the Group's clearing business, Hong Kong Registrars Limited (HKRL), a wholly-owned subsidiary, were sold and merged with those of Central Registration Hong Kong Limited, which has been renamed as Computershare Hong Kong Investor Services Limited (CHIS). The Group received 18 per cent of the issued share capital of CHIS as consideration for the sale of HKRL. On the same date, the Group increased its holding in CHIS to 24 per cent by acquiring a further 6 per cent of the issued share capital of CHIS by cash.

Exposure to Fluctuations in Exchange Rates and Related Hedges

When seeking to optimise returns on its funds available for investment, the Group may invest in non-HKD securities from time to time. Forward foreign exchange contracts or foreign currency credit facilities may be used to hedge the currency exposure of the Group's non-HKD investments to mitigate risks arising from fluctuations in exchange rates. As at 31 December 2002, aggregate net open foreign currency positions amounted to HK$1,924 million, of which HK$200 million were non-USD exposures (2001: HK$1,947 million, of which HK$72 million were non-USD exposures). The Group's foreign currency liabilities, in the form of margin deposits or collateral received, are hedged by investments in the same currencies.

Contingent Liabilities

The Unified Exchange Compensation Fund (Compensation Fund) is a fund set up under the Securities Ordinance (SO) for the purpose of compensating any person dealing with a Stock Exchange Participant (other than another Stock Exchange Participant) for any pecuniary losses suffered as a result of a default of the Stock Exchange Participant. According to section 109(3) of the SO, the maximum compensation amount is $8 million for each Stock Exchange Participant's default. Under section 113(5A) of the SO, the Stock Exchange may, upon satisfying certain conditions, with the approval of the Securities and Futures Commission (SFC), allow an additional payment to the successful claimants before apportionment. Under section 107(1) of the SO, the Stock Exchange has contingent liabilities to the Compensation Fund as it shall replenish the Compensation Fund upon the SFC's request to do so. The amounts to be replenished should be equal to the amount paid in connection with the satisfaction of the claims, including any legal and other expenses paid or incurred in relation to the claims but capped at $8 million per default. As at 31 December 2002, there were outstanding claims received in respect of 14 defaulted Stock Exchange Participants (2001: 15).

Under the new compensation arrangements to be implemented on 1 April 2003 under the Securities and Futures Ordinance (SFO), a new Investor Compensation Fund would replace the existing Compensation Fund, the Commodity Exchange Compensation Fund and the Dealers' Deposit Schemes for non-exchange participant dealers. The new arrangements would not require Exchange Participants to make deposits to the Investor Compensation Fund. Existing deposits would be returned to the Stock Exchange and the Futures Exchange in accordance with the provisions of the SFO. The arrangements would remove the requirement for the Stock Exchange to replenish the Investor Compensation Fund.

The Stock Exchange has undertaken to indemnify the Collector of Stamp Revenue against any loss of revenue resulting from any underpayment or default or delay in payment of stamp duty by its Participants, up to $200,000 in respect of default of any one Participant. In the unlikely event that all of its 471 trading Participants as at 31 December 2002 (2001: 492) default, the maximum contingent liability of the Stock Exchange under the indemnity will amount to $94 million (2001: $98 million).

Pursuant to Section 21 of the Exchanges and Clearing Houses (Merger) Ordinance, HKEx gave an undertaking on 6 March 2000 in favour of HKSCC to contribute an amount not exceeding $50 million in the event of HKSCC being wound up while it is a wholly-owned subsidiary of HKEx or within one year after HKSCC ceases to be a wholly-owned subsidiary of HKEx, for payment of the debts and liabilities of HKSCC contracted before HKSCC ceases to be a wholly-owned subsidiary of HKEx, and for the costs, charges and expenses of winding up.

HKEx has given a guarantee to secure banking facilities granted to HKSCC since 13 December 2000. These facilities, on a committed basis of an aggregate amount of $1.1 billion, were granted to HKSCC by five banks to provide stand-by liquidity to meet the obligations of HKSCC in CCASS in circumstances where the CCASS Participants default on their payment obligations. As at 31 December 2002 and 31 December 2001, none of these banking facilities was utilised.

HKEx has given a guarantee to secure banking facilities of SGD12 million to HKEx (Singapore) Limited for financing its investments since 16 April 2001. As at 31 December 2002, SGD11 million (equivalent to HK$49 million) of the facility was drawn down (2001: SGD11 million, equivalent to HK$46 million). The loan will mature within one year and has a fixed rate of interest.

Employees

HKEx has developed its human resources policies and procedures based on performance and merit. The Group ensures that the pay levels of its employees are competitive and employees are rewarded on a performance-related basis within the general framework of the Group's salary and bonus system.

Share options may be granted to Executive Directors and employees of the Group to subscribe for shares in HKEx in accordance with the terms and conditions of the Share Option Schemes approved by the shareholders of HKEx at an extraordinary general meeting held on 31 May 2000.

Following the merger of the businesses of the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group in 2000, HKEx has succeeded in streamlining its workforce and the number of employees fell from 1,052 prior to the merger to 797 as at 31 December 2002. Total employees' cost was reduced by $106 million or 18 per cent from $599 million in 2000 to $493 million in 2002.

Prospects

As a substantial part of HKEx's income is derived from trading fees, clearing and settlement fees, listing fees and interest income, the performance of the Group is heavily influenced by external factors including, in particular, market sentiment, the level of activities on the Stock Exchange and Futures Exchange, as well as movements in interest rates.

Given the importance of external factors to HKEx's performance, the year ahead is likely to remain challenging, not least because of the risk of war in the Middle East, fear of terrorist activities worldwide, and uncertainties over the economic performance in the United States, Europe and Japan.

The uncertain external environment, coupled with the likely continuation of high unemployment, deflation, and weak property prices domestically would suggest that activity on the securities and derivatives markets is likely to remain subdued, at least in the first half of 2003, and this could have an adverse impact on revenues.

To meet the challenges ahead, HKEx will seek to further raise the quality of its markets and ensure that its services remain competitive. It will pursue initiatives to attract more investors and capital raising companies to Hong Kong. To develop a more diverse income base, the Group will further introduce new financial products. It will seek additional opportunities for business co-operation and alliances with exchanges and clearing houses on the Mainland China and overseas. Stringent cost control will be maintained over the Group's operating costs.

Following China's accession to the World Trade Organisation, the pressure on both public and private enterprises to upgrade themselves in the face of market liberalisation would increase. Thus, it can be anticipated that these private enterprises from the Mainland would be contemplating raising capital in the securities market, including listing in Hong Kong. By virtue of its unrivalled geographic proximity and ties with the Mainland, Hong Kong is well positioned to benefit from this. In forging closer economic co-operation with the Mainland, the Hong Kong Government and the private sector are taking initiatives to expedite the economic integration with the rapidly growing economy of the Pearl River Delta. Discussions on a Closer Economic Partnership Arrangement between the Mainland and Hong Kong are expected to come to fruition with agreement on the main parts by June 2003. These are expected to boost capital formation activities in Hong Kong. The Group will closely monitor economic and capital market developments on the Mainland. It will continue to focus its marketing efforts in the Mainland and strive to strengthen Hong Kong's position as the primary international capital raising centre for Mainland companies.