



# Management Discussion and Analysis

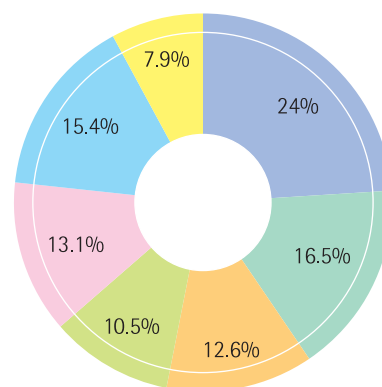
(Financial figures are expressed in Hong Kong dollars)

## OVERALL PERFORMANCE

The Group recorded a profit attributable to shareholders of \$692 million for the year (2003 first quarter: \$89 million; 2003 second quarter: \$125 million; 2003 third quarter: \$190 million; 2003 fourth quarter: \$288 million), compared with \$588 million for 2002 (2002 first quarter: \$118 million; 2002 second quarter: \$171 million; 2002 third quarter: \$138 million; 2002 fourth quarter: \$161 million). The 18 per cent or \$103 million increase in profit was mainly attributable to the increase in cash and derivatives market activities in the latter half of the year, which has caused an increase in revenue from trading fees and trading tariff, and clearing and settlement fees.

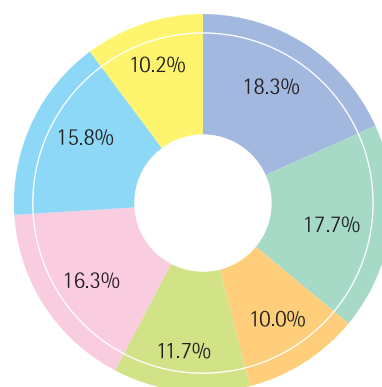
Total operating expenses increased by \$57 million or 5 per cent to \$1,222 million (2002: \$1,165 million), primarily attributable to one-off costs incurred in 2003 second quarter that are not expected to recur in the coming few years. The one-off costs included a write-down of strategic investments (\$33 million), retirement of redundant IT systems (\$10 million), and severance costs (\$9 million) following the review of the Group's business strategy and operations in May 2003. After taking into account tax deduction available, the one-off costs reduced the Group's profit by \$51 million in 2003. Moreover, there was a one-off increase in deferred tax charge of \$6 million in 2003 following the implementation of the new Hong Kong Statement of Standard Accounting Practice (SSAP) 12: Income Taxes, which became effective on 1 January 2003.

### Analysis of 2003 Income



- Trading fees and trading tariff
- Stock Exchange listing fees
- Clearing and settlement fees
- Depository, custody and nominee services fees
- Income from sale of information
- Investment income
- Other income

### Analysis of 2002 Income



- Trading fees and trading tariff
- Stock Exchange listing fees
- Clearing and settlement fees
- Depository, custody and nominee services fees
- Income from sale of information
- Investment income
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Had the above-mentioned one-off costs (\$51 million after tax) and deferred tax charge (\$6 million) not been incurred, after-tax profit attributable to shareholders for the year would have been \$749 million, which would be \$161 million or 27 per cent higher than that in 2002.

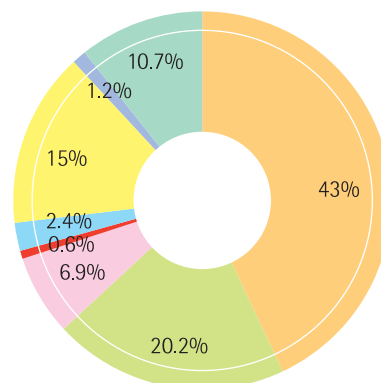
## Income

Total income (including share of profits less losses of associated companies) for the year increased by \$213 million or 12 per cent to \$2,027 million (2002: \$1,814 million).

Bolstered by improved investor sentiment, the cash market rebounded distinctly in the second half of the year, after the setback caused by the Severe Acute Respiratory Syndrome in the second quarter. Average daily turnover on The Stock Exchange of Hong Kong Limited (Stock Exchange) for the year increased by 55 per cent to \$10.4 billion, compared with \$6.7 billion in 2002. Average daily number of stock options contracts traded on the Stock Exchange increased by 13 per cent in 2003 compared with that in 2002. Average daily number of derivatives contracts traded on Hong Kong Futures Exchange Limited (Futures Exchange) increased by 39 per cent, mainly on account of an increase in the trading of Hang Seng Index (HSI) Futures contracts. Consequently, income from trading fees and trading tariff rose by \$153 million or 46 per cent to \$485 million (2002: \$332 million).

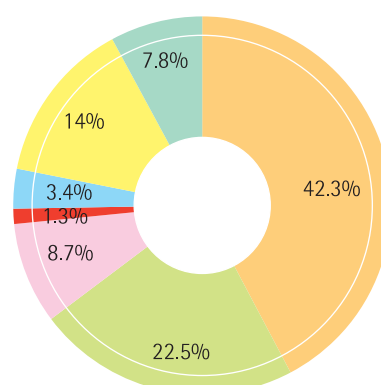
Listing fee income rose by \$14 million or 4 per cent to \$334 million (2002: \$320 million), largely because of an increase in initial listing fees, and a rise in annual listing

### Analysis of 2003 Expenses



- Staff costs and related expenses
- Information technology and computer maintenance expenses
- Premises expenses
- Product marketing and promotion expenses
- Legal and professional fees
- Depreciation and amortisation
- Payment to SFC under dual filing regime
- Other operating expenses

### Analysis of 2002 Expenses



- Staff costs and related expenses
- Information technology and computer maintenance expenses
- Premises expenses
- Product marketing and promotion expenses
- Legal and professional fees
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fees due to a higher number of listed securities. The increase in initial listing fees was primarily as a result of higher number of initial public offerings (IPOs) processed. Although the number of new listings fell compared with 2002, the reduction in initial listing fees from new listings was more than offset by initial listing fees forfeited due to increased numbers of lapsed and withdrawn IPO applications and approved IPOs not listed within six months of application. A total of 46 (2002: 60) new companies joined the Main Board and 27 (2002: 57) the Growth Enterprise Market (GEM) during the year. As at 31 December 2003, 3 Main Board and 5 GEM (31 December 2002: 13 Main Board and 7 GEM) IPO applications had obtained approval in principle from the Listing Committee for listing, and 19 Main Board and 32 GEM applications were under processing (31 December 2002: 35 Main Board and 72 GEM). As at 31 December 2003, there were 852 companies listed on the Main Board and 185 on GEM (31 December 2002: 812 and 166 respectively).

In line with the increase in cash market activities, clearing and settlement fee income increased by \$74 million or 41 per cent to \$255 million (2002: \$181 million).

Depository, custody and nominee services fee income only increased by \$1 million or 0.1 per cent to \$212 million (2002: \$211 million) as higher fees from electronic IPOs and dividend/interest collection were offset by lower stock custody fees, which was partly due to stock consolidation undertaken by issuers in 2003.

Income from sale of information declined by \$30 million or 10 per cent to \$264 million (2002: \$294 million), due to the consolidation of broking firms and lower demand for stock information. However, demand for information started to pick up in the second half of 2003 as the market became more buoyant.

Investment income comprises income from investments supervised by the Treasury Division, investment in Singapore Exchange Limited and accommodation income on securities deposited by Participants as alternatives to cash deposits of the margin funds. Total investment income for the Group increased by 9 per cent or \$26 million to \$311 million (2002: \$285 million).

For investments supervised by the Treasury Division, income for the year amounted to \$293 million, 5 per cent or \$15 million higher than the \$278 million reported for last year. The increase was due to higher net realised gain at \$35 million (2002: loss of \$14 million), net unrealised mark-to-market gain at \$43 million (2002: \$33 million) on the investment portfolio, and dividends at \$4 million (2002: \$3 million), but partly offset by lower net interest income at \$211 million (2002: \$256 million) due to lower interest rates. As the valuation of the investments in bonds and equities reflects movements in their market prices, unrealised gains or losses may fluctuate or reverse unless the investments are sold.

During the two years under review, the average 6-month Hong Kong Exchange Fund Bill rate dropped from 1.70 per cent in 2002

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to 0.84 per cent in 2003, and the average 90-day US Treasury Bill rate declined from 1.62 per cent to 1.02 per cent.

For the year ended 31 December 2003, the Group achieved a positive return on investments of 2.76 per cent (2002: 3.10 per cent). The Corporate Funds returned 4.25 per cent (2002: 3.92 per cent), the margin funds 1.55 per cent (2002: 2.10 per cent), and the Clearing House Funds 1.56 per cent (2002: 2.60 per cent). Therefore, the overall portfolio recorded a spread of 192 basis points above the 6-month Hong Kong Exchange Fund Bill yield (2002: 140 basis points) with the Corporate Funds registering a spread of 341 basis points (2002: 222 basis points), the margin funds 71 basis points (2002: 40 basis points), and the Clearing House Funds 72 basis points (2002: 90 basis points) above the 6-month Hong Kong Exchange Fund Bill yield.

The average amount of funds available for investment increased by \$1.5 billion or 17 per cent to \$10.6 billion (2002: \$9.1 billion), mainly due to a rise in margin funds received from Clearing Participants as a result of increased trading in futures and options contracts. As at 31 December 2003, 59 per cent (2002: 44 per cent) of the funds were invested in cash or bank deposits, 39 per cent (2002: 55 per cent) in investment-grade bonds with an average credit rating of Aa2, and 2 per cent (2002: 1 per cent) in global equities. For more details of the investment portfolios supervised by the Treasury Division, please refer to the section on Treasury in Review of Operations.

Income from investment in Singapore Exchange Limited increased by 924 per cent or \$12 million to \$13 million (dividend of \$14 million less interest expense of \$1 million for funding the investment) in 2003 from \$1 million (dividend of \$2 million less interest expense of \$1 million) in 2002, mainly attributable to a special dividend of \$12 million received during the year. Accommodation income (i.e., retention interest charged on securities deposited by Participants as alternatives to cash deposits of the margin funds) dropped by 8 per cent or \$1 million to \$5 million (2002: \$6 million).

Other income decreased by \$26 million or 14 per cent to \$159 million (2002: \$185 million), mainly due to a \$7 million reduction in brokerage on direct IPO applications from \$19 million in 2002 to \$12 million in 2003, and a \$17 million decrease in share registration services fees following the disposal in May 2002 of the Group's share registration operations, Hong Kong Registrars Limited, in return for an 18 per cent shareholding in an associated company, Computershare Hong Kong Investor Services Limited (CHIS). The Group's share of CHIS's profit is included under Share of Profits Less Losses of Associated Companies in the Consolidated Profit and Loss Account.

## Operating Expenses

Total operating expenses increased by \$57 million or 5 per cent to \$1,222 million (2002: \$1,165 million), primarily as a result of \$52 million of one-off costs incurred in 2003 second quarter that are not expected to recur in the near future.

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Staff costs and related expenses increased by \$33 million or 7 per cent to \$526 million (2002: \$493 million), largely due to higher severance costs of \$12 million (of which \$9 million was one-off costs incurred following the reorganisation and streamlining of the Group's operations in May 2003), and the payment of performance bonus of \$15 million (2002: \$Nil) due to improved performance of the Group.

Information technology and computer maintenance expenses fell by \$16 million or 6 per cent from \$263 million in 2002 to \$247 million in 2003, mainly attributable to lower hardware and software rental but partly offset by expenditures relating to the maintenance of the upgraded Central Clearing and Settlement System (CCASS/3) rolled out in May 2002.

Premises expenses fell by \$17 million or 17 per cent to \$84 million (2002: \$101 million) as lower rental was negotiated upon the renewal of certain leases.

Legal and professional fees decreased by \$11 million or 27 per cent to \$29 million (2002: \$40 million), primarily as a result of professional fees incurred for several one-off consulting projects in 2002.

Depreciation and amortisation costs increased by \$20 million or 12 per cent to \$183 million (2002: \$163 million), mainly due to the additional depreciation charge arising from the roll-out of CCASS/3 in May 2002.

Payment to the Securities and Futures Commission (SFC) under the dual filing regime started from 1 April 2003 and amounted to \$15 million (2002: \$Nil).

Other operating expenses rose by \$40 million or 44 per cent to \$131 million (2002: \$91 million), mainly attributable to one-off items not expected to recur in the near future, which included the write-down of a 100 per cent (\$32.3 million) of the Group's investment in BondsInAsia Limited and \$0.4 million of investment in ADP Wilco Processing Services Limited, and the retirement of redundant IT systems (\$10 million) following the review of the Group's business strategy and operations in May 2003.

The Group's taxation charge rose by \$53 million or 86 per cent to \$114 million (2002: \$61 million), mainly on account of an increase in net profit and Hong Kong Profits Tax rate from 16 per cent to 17.5 per cent announced in the March 2003 Hong Kong Budget (\$34 million), the tax charge on non-deductible expenses including part of the one-off costs mentioned above (\$6 million) and an increase of \$7 million due to prior year taxation (prior year underprovision of \$1 million booked as a charge in 2003 compared with prior year overprovision of \$6 million reversed as a credit in 2002). In addition, there was a one-off increase in deferred tax charge of \$6 million as, under the new SSAP 12: Income Taxes, effective from 1 January 2003, outstanding deferred tax liabilities brought forward from 2002

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(calculated at the 16 per cent tax rate in 2002) have to be recomputed in 2003 by using the higher rate of 17.5 per cent.

## **Liquidity, Financial Resources, Gearing and Capital Commitments**

Working capital increased by \$256 million or 6 per cent to \$4,463 million as at 31 December 2003 (2002: \$4,207 million), mainly due to current year profit retained. Bank balances and time deposits of corporate funds increased by \$793 million or 80 per cent to \$1,778 million (2002: \$985 million).

Although the Group has consistently been in a very liquid position, banking facilities have nevertheless been put in place for contingency purposes. As at 31 December 2003, the Group's total available credit facilities amounted to \$2,764 million (2002: \$2,763 million), of which \$1,500 million were repurchase facilities to augment the liquidity of the margin funds and \$1,100 million were for meeting the Group's Continuous Net Settlement money obligations of Hong Kong Securities Clearing Company Limited (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 2003, the only facility drawn down was a fixed rate bank loan of SGD11 million (equivalent to HK\$50 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 Exchange Limited (2002: SGD11 million, equivalent to HK\$49 million).

As at 31 December 2003, 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 (2002: less than 1 per cent).

The Group's capital expenditure commitments, largely in respect of its ongoing investments in facilities and technology, amounted to \$91 million as at 31 December 2003 (2002: \$94 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 2003, 98 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**

The Group did not have any charges on assets as at 31 December 2003 and 31 December 2002.

## **Significant Investments Held and Material Acquisitions and Disposals of Subsidiaries**

The Group has been holding 1 per cent of the issued ordinary share capital of Singapore



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Exchange Limited since November 2000 (cost: \$49.1 million; and market value: \$77.2 million), 14.47 per cent of the issued ordinary share capital of BondsInAsia Limited since April 2002 (cost: \$32.3 million; and book value: \$Nil), and 24 per cent of Computershare Hong Kong Investor Services Limited (cost: \$26.5 million; and book value: \$32.6 million) and 30 per cent of ADP Wilco Processing Services Limited since May 2002 (cost: \$1.8 million; and book value: \$1.4 million).

During the year, the Group has written down 100 per cent (\$32.3 million) of the value of its investment in BondsInAsia Limited, and 21 per cent (\$0.4 million) of investment in ADP Wilco Processing Services Limited to the Group's share of the net assets of this associated company due to impairment.

There were no material acquisitions or disposals of investments and subsidiaries during the year.

### 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 2003, aggregate net open foreign currency positions amounted to HK\$1,663 million, of which HK\$204 million were non-USD exposures (2002: HK\$1,924 million, of which HK\$200

million were non-USD exposures). The Group's foreign currency liabilities, mainly in the form of margin deposits or collateral received, are hedged by investments in the same currencies.

### Contingent Liabilities

The Compensation Fund is a fund set up under the repealed 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 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 2003, there were outstanding claims received in respect of 13 defaulted Stock Exchange Participants (2002: 14).

Pursuant to the Securities and Futures Ordinance (SFO), the Stock Exchange issued a notice on 3 April 2003 inviting for claims

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against the Compensation Fund in relation to any default of a Stock Exchange Participant occurring before 1 April 2003. The claims period expired on 3 October 2003 and no claims had been received in response to that notice. Claims made after the claims period shall, unless the Stock Exchange otherwise determines, be barred. As at 31 December 2003, no such claims had been received.

Under the new compensation arrangements implemented under the SFO, a new Investor Compensation Fund has replaced 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. In accordance with the provisions of the SFO, deposits to the Commodity Exchange Compensation Fund had been returned to the Futures Exchange by the SFC in January 2004. The Futures Exchange had in turn reimbursed holders of Futures Exchange Trading Rights their contributions to the Commodity Exchange Compensation Fund. Existing deposits to the Unified Exchange Compensation Fund would be returned to the Stock Exchange in accordance with the provisions of the SFO. There is no 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 437 trading Participants as at 31 December 2003 (2002: 471) default, the maximum contingent liability of the Stock Exchange under the indemnity will amount to \$87 million (2002: \$94 million).

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 CCASS Participants default on their payment obligations. As at 31 December 2003 and 31 December 2002, 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 2003, SGD11million (equivalent to HK\$50 million) of the facility was drawn



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down (2002: SGD11 million, equivalent to HK\$49 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 the Chief Executive and employees of the Group to subscribe for shares in HKEx in accordance with the terms and conditions of the Share Option Scheme 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 (including 88 temporary staff) prior to the merger to 803 (including 38 temporary staff) as at 31 December 2003. Total employees' cost increased by \$33 million or 7 per cent from \$493 million in 2002 to \$526 million in 2003, mainly due to higher severance costs of \$12 million (of which \$9 million were one-off costs incurred following the reorganisation and streamlining of the Group's operations in May 2003), and the payment of performance bonus due to improved performance of the Group.

### 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 activity on the Stock Exchange and Futures Exchange, and movements in interest rates. The recent increases in trading activities in the cash and derivatives markets suggest that investor confidence has rebounded significantly. The external environment is likely to be influenced by low interest rate levels, Mainland China's rapid economic growth, and movements in the currency markets. In this climate, investment funds will likely continue to be drawn to equities. The inflow of international funds will continue to bring about a favourable environment for the listing of major enterprises, in particular those from the Mainland. These factors suggest a more promising outlook for Hong Kong's financial market.

The Expert Group appointed by the Government to review the operation of the securities and futures market regulatory structure recommended on 21 March 2003 various market reform measures, including the transfer of the listing function on a bottom-line neutral basis from the Group to the SFC. In light of this, the Government issued a consultation paper to seek public views on enhancing listing regulations on 3 October 2003. HKEx submitted its views in January 2004. HKEx supports the proposal to expand the existing dual filing system as they would benefit the market and require

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minimal changes. HKEx will further improve the listing regulatory structure based on the outcome of the Government's review, and continue to work closely with the Government and the SFC on measures to raise the quality of Hong Kong's financial markets.

HKEx will continue to exercise control over its costs vigilantly, and to develop new financial products and services to meet investor needs. It will seek to further raise the quality and efficiency of its markets to increase their competitiveness. Continued investments in market infrastructure will be made to ensure that it remains robust and reliable. HKEx will also encourage more fund-raising activities on the Stock Exchange and strengthen its position among the world's equity markets.

Mainland related activities have buoyed and exerted a dynamic impact on the size and trading volume of Hong Kong's equities market. The rapid economic development and continued market reform of China could lead to an increasing number of financially important and large-scale state and other

enterprises seeking listings in Hong Kong. The Closer Economic Partnership Arrangement (CEPA) between the Mainland and Hong Kong will provide opportunities for HKEx to further develop its Mainland business. The official establishment of HKEx's Beijing Representative Office in November 2003 will enable HKEx to better promote its services to mainland enterprises. We are looking into stationing staff in other Mainland cities including Shanghai and Guangzhou. HKEx will focus its marketing efforts in Mainland China, and expand its business network in the Mainland through promotional and educational activities. HKEx will continue to develop China-related products and enhance listing services to Mainland issuers in order to attract more major, high quality Mainland enterprises to list in Hong Kong. HKEx will further explore possible business co-operation with the Mainland exchanges.

HKEx will strive to maintain an open, secure, fair, orderly and transparent marketplace contributing to Hong Kong's status as an international financial centre and premier capital market for China.