Management Discussion and Analysis

(Financial figures are expressed in Hong Kong dollars)

OVERALL PERFORMANCE

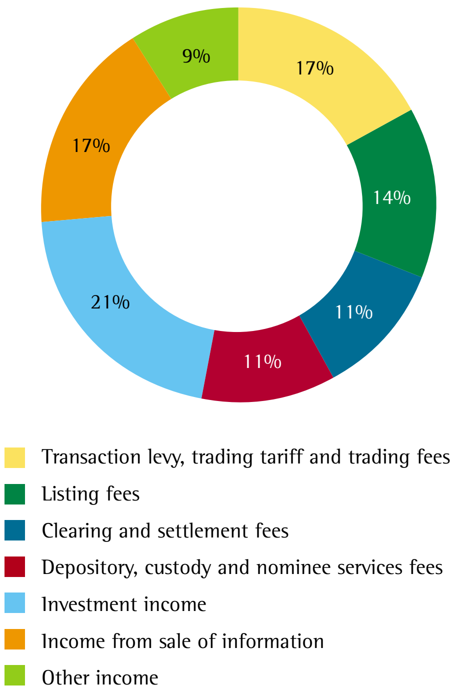
The Group recorded a profit attributable to shareholders of $740 million for the year, compared with $874 million as restated for 2000. Despite a severe deterioration in market conditions, which has caused a 35 per cent reduction in cash market volume and a corresponding drop in transaction levy (replaced by a trading fee at the same level on 1 September 2001), trading tariff, clearing and settlement fees, profit attributable to shareholders contracted by 15 per cent. This was achieved through more proactive management of investments, a diversified revenue source, and the Group's success in significantly cutting its total operating costs by $156 million (or 12 per cent).

Income

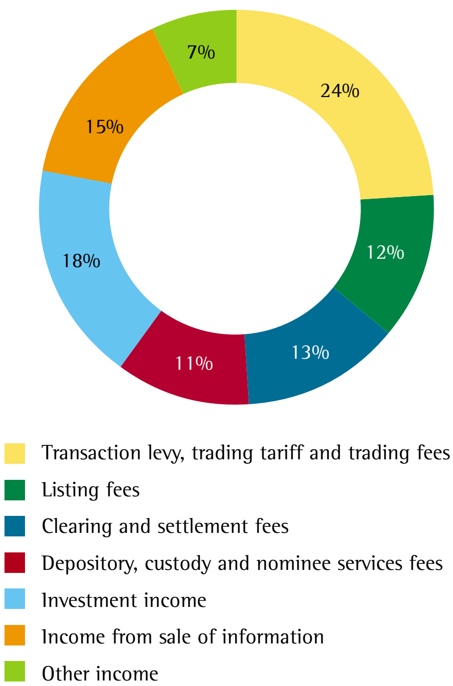
Total income for the year fell by 14 per cent to $1,998 million (2000: $2,312 million).

As US economic growth slowed and Japan entered into another recession, global economic outlook continued to deteriorate in 2001. Coupled with falling property prices and rising unemployment, investor sentiment in Hong Kong worsened further. Average daily turnover of the cash market dropped by 35 per cent in 2001 compared to 2000. Although the average daily number of derivatives contracts traded on

Analysis of 2001 Income



Analysis of 2000 Income



Hong Kong Futures Exchange Limited (the Futures Exchange) increased by 23 per cent due to more active trading in Hang Seng Index (HSI) Futures contracts, the fall in cash market activities, together with a reduction in the Group's entitlement to transaction levy from cash market trading from 0.007 per cent to 0.005 per cent since June 2000, has caused total transaction levy, trading tariff and trading fees to drop by 36 per cent to $351 million (2000: $548 million).

Despite the depressed market conditions, 31 new companies joined the Main Board and 57 the Growth Enterprise Market (GEM) during the year, raising $25.7 billion of new capital. Listing fee income rose by 2 per cent to $275 million (2000: $270 million), primarily on account of a higher number of listed securities. As at 31 December 2001, there were 756 companies listed on the Main Board and 111 on GEM (31 December 2000: 736 and 54 respectively).

In line with decreased cash market activities, clearing and settlement fee income dropped by 30 per cent to $214 million (2000: $305 million). Depository, custody and nominee services fee income also decreased by 11 per cent to $228 million (2000: $258 million) as corporate actions fell during the year.

In an effort to forestall the US economy from sliding into a deep recession, the Federal Reserve cut interest rates aggressively during the year to a 40-year low. Although interest rates fell by 475 basis points from 6.5 per cent to 1.75 per cent, and the amount of funds available for investment shrank by 15 per cent (from $10.2 billion to $8.7 billion) as a result of a drop in margin funds received, investment income was maintained at $414 million, the same level as 2000, primarily attributable to improved asset allocation from bank deposits to high-grade bonds.

Net interest income declined by 8 per cent but the drop was largely offset by capital gains in bonds and other securities. As of 31 December 2001, the 6-month Hong Kong Government Exchange Fund Bill rate was 1.78 per cent and the 90-day U.S. Treasury Bill rate was 1.72 per cent. Gross annual return on the Group's investments was 5.09 per cent (representing an average effective return on bonds of 6.66 per cent and 3.89 per cent on other investments). All bonds held were of investment grade and had a weighted average credit rating of Aa3.

Operating Expenses

Total operating expenses dropped by 12 per cent to $1,176 million (as restated 2000: $1,332 million), mainly as a result of stringent cost controls and the realisation of operating efficiencies since the merger.

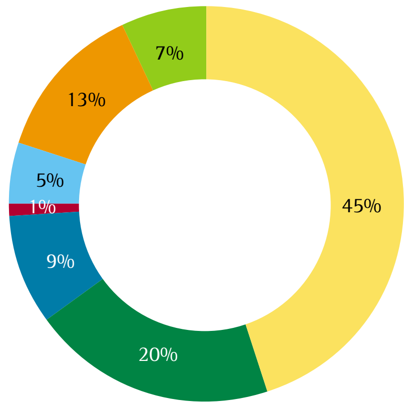
Staff costs and related expenses decreased by 12 per cent to $528 million (2000: $599 million). Following the integration of its activities, the Group streamlined its operations and shifted from a lower-cost operational staff mix to a more knowledge-based IT and product/marketing oriented staff mix. Significant cost savings were achieved due to headcount reduction (average headcount fell by 10 per cent) and prudent controls exercised over other staff-related expenditures.

Due to the Group's commitment to constantly enhance the capability of its trading and settlement systems, information technology and computer maintenance expenses increased by 7 per cent from $217 million to $231 million, mainly attributable to expenditures incurred on the new Order Routing System and integration of the trading systems for stock options and other options and futures.

Through consolidating premises occupied by the Group after the merger and integration, premises expenses were reduced by 8 per cent to $100 million (2000: $109 million).

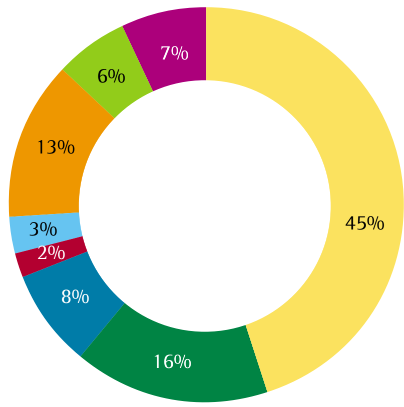
Product marketing and promotion expenses dropped by 50 per cent to $15 million (2000: $31 million) as there were several large-scale one-off promotion events in 2000, such as the new Investor Account Services for the clearing business, listing of

Analysis of 2001 Expenses



- Staff costs and related expenses
- IT and computer maintenance expenses
- Premises expenses
- Product marketing and promotion expenses
- Legal and professional fees
- Depreciation and amortisation
- Other operating expenses

Analysis of 2000 Expenses



- Staff costs and related expenses
- IT and computer maintenance expenses
- Premises expenses
- Product marketing and promotion expenses
- Legal and professional fees
- Depreciation and amortisation
- Other operating expenses
- Merger, listing and integration expenses

the Group and migration from the trading floor to the Hong Kong Futures Automated Trading System (HKATS).

Legal and professional fees for the year increased from $32 million to $62 million, mainly due to professional fees incurred for reviewing the Group's strategic plan and related initiatives to position the Group for future growth and development in various business segments.

Depreciation and amortisation costs declined by 14 per cent to $153 million (2000: $177 million), mainly attributable to a one-off depreciation charge of $25 million in 2000 as a result of the standardisation of the Group's policy on depreciation. Additional depreciation charge arising from the roll-out of AMS/3 in October 2000 was more than offset by the decrease in depreciation for the Traded Option System for stock options, which was fully depreciated in August 2000.

Other operating expenses rose by 17 per cent to $87 million (2000: $74 million) mainly on account of fees payable to external fund managers and provisions for doubtful debts.

There were no merger, listing and integration expenses during the year as all such costs were incurred and fully provided for in 2000.

Taxation

The Group's taxation charge in 2001 decreased by 22 per cent to $82 million (2000: $106 million), primarily due to the lower profit reported for the year.

LIQUIDITY, FINANCIAL RESOURCES, GEARING AND CAPITAL COMMITMENTS

Working capital increased by 23 per cent to $4,037 million at 31 December 2001 (as restated 2000: $3,276 million) mainly on account of profit attributable to shareholders for the year and the switching of non-trading securities maturing over one year to trading securities. Following the finalisation of the new Investment Policy in mid 2001, the Group moved its corporate fund investments from non-trading securities and low yield bank deposits to investment grade marketable trading securities. As a result, trading securities increased by $3,183 million (2000: $Nil) while bank balances and time deposits declined by 56 per cent to $1,600 million (2000: $3,635 million).

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 2001, the Group's total available credit facilities amounted to $2,875 million (2000: $2,895 million), of which $1,600 million were repurchase facilities for maintaining the liquidity of the margin funds and $1,100 million were for meeting 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 the year-end, the only facility drawn down was a fixed rate bank loan of SGD11 million (equivalent to HK$46 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 (2000: $Nil). The loan will be renewed annually if necessary.

As at 31 December 2001, the Group's gearing ratio, measured on the basis of total borrowings as a percentage of total shareholders' equity, was less than one per cent (2000: zero per cent).

As at 31 December 2001, the Group's capital expenditure commitments, mainly in respect of its ongoing investments in facilities and technology, amounted to $317 million (2000: $381 million). The Group has adequate financial resources to fund its commitments on capital expenditure from its existing cash resources and cash flows generated from its operations.

CHARGES ON ASSETS

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. As at 31 December 2001 and 31 December 2000, this overdraft facility was not utilised.

SIGNIFICANT INVESTMENTS HELD AND MATERIAL ACQUISITIONS AND DISPOSALS OF SUBSIDIARIES

Other than the 1 per cent holding (10 million shares) in the issued ordinary share capital of the Singapore Exchange Limited acquired in 2000, there were no significant investments or disposals of subsidiaries in 2001.

EXPOSURE TO FLUCTUATIONS IN EXCHANGE RATES AND RELATED HEDGES

The Group's foreign currency liabilities, mostly in the form of margin deposits or collateral received, are hedged by investments in the same currencies. As at 31 December 2001, aggregate net open foreign currency positions amounted to HK$1,947 million, of which HK$72 million was non-USD exposures (31 December 2000: HK$55 million and all non-USD exposures).

CONTINGENT LIABILITIES

The 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 defaults 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 of Hong Kong Limited (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 2001, there were outstanding claims received in respect of 15 defaulted Stock Exchange Participants (2000: 18).

Under the new investor compensation arrangements proposed by the SFC in March 2001 to be implemented under the Securities and Futures Bill, a new single 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 eliminate the existing requirement for Exchange Participants and non-exchange participant dealers to make deposits to the Compensation Funds and Dealers' Deposit Schemes respectively. Existing deposits would be returned to the Exchange Participants and to non-exchange participant dealers. The arrangements would also remove the existing requirement for the Stock Exchange to replenish the 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 defaults of any one Participant. In the unlikely event that all of the 492 trading Participants as at 31 December 2001 (2000: 500) default, the maximum contingent liability of the Stock Exchange under the indemnity will amount to $98 million (2000: $100 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 2001 and 31 December 2000, 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 2001, SGD11 million (equivalent to HK$46 million) of the facility was drawn down. 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 830 as at 31 December 2001. Total employees' cost (excluding Directors' emoluments) fell from $591 million in 2000 to $520 million in 2001.

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, and movements in interest rates. While recent economic indicators suggest that the US economy may be on the path of recovery, the speed or robustness of that recovery is still uncertain. Also, continued high unemployment and deflationary pressure in Hong Kong are expected to continue to undermine consumer confidence and investor sentiment. Until there are clear signs of recovery in the US and in Hong Kong, activities on the Stock Exchange and Futures Exchange may remain subdued in the first half of 2002. This could have an impact on the Group's revenue in 2002.

The year ahead will continue to be challenging given the economic uncertainties. To meet the challenges, the Group will continue to improve the quality of its markets to increase their attractiveness and liquidity. More efforts will be dedicated to developing and marketing new products, such as international and regional benchmark financial products, to attract both local and international investors. The Group will further enhance the capability of its trading and clearing systems and broaden access to facilitate trading, such as through extended trading hours and remote trading access programmes for cash and derivatives products. It will aggressively examine its long-term strategy and proactively pursue strategic initiatives that will attract investors and capital raising companies to Hong Kong. The Group will continue to develop ties with Mainland exchanges and explore opportunities for business co-operation and alliances with overseas exchanges and other strategic partners. Stringent control will be maintained over the Group's operating costs.

With China's accession to the World Trade Organisation (WTO) and its intention to enter into a closer economic partnership arrangement with Hong Kong, the Special Administrative Region will become even more attractive as a two-way gateway between China and the rest of the world. Moreover, it will act as an important capital raising centre for Mainland companies wishing to raise capital in order to compete more effectively overseas or with foreign entrants into the PRC market. Positive developments brought about by China's WTO membership will benefit the financial market in Hong Kong in the long-run, and the Group will double its efforts to explore and capitalise on those opportunities.