Management Discussion and Analysis

The following discussion and analysis should be read in conjunction with the financial information of the Group contained in the financial statements (together with the notes thereto) included elsewhere in this Annual Report.

Core Values

The core values of the China Merchants Group as a whole, including the Group, are: Unity, Practicality, Stringency and Efficiency.

It is apparent that a high level of professionalism has been built into the operations of both the China Merchants Group and CMHI; this is a particularly important issue since CMHI has the responsibility to both its stakeholders and society as a whole. The mission of CMHI as indicated in our Chairman's Statement – to maximize shareholders' value – is in essence an embodiment of the above core values of the Group.

Another value that has been well preserved by the Group is the provision of adequate training to its staff, who form an important part of our stakeholders. Lastly, with a team of sophisticated and experienced independent non-executive Directors, both the issues of independence and value-adding to Shareholders have also been satisfied in a professional manner.

Challenges & Opportunities

CMHI together with other companies operating in this region have been facing similar difficult issues in their operations. These issues include the uncertainty and loss in consumer confidence as a result of the "September 11" incident (although now this has proven to be overly-pessimistic), the continous downsizing of major corporations, and a slow down in the Hong Kong economy. As recent economic statistics released in the US have shown a possible revival in its economy, the concern for corporations is now more on the reversal of the interest rate trend, i.e. on an upward trend. It is not certain whether benefits from improvement in the US and the global economy can outweigh the costs of increased interest rates, but CMHI will certainly benefit from an economic turnaround scenario.

As for opportunities, given China's entry into the WTO and the upcoming Olympics in 2008, especially from the perspective of infrastructure construction, CMHI is confident that these events will enhance the continual growth of China's economy (which is still the most important market for CMHI) which will translate into more business for CMHI in terms of container throughput. Also, as China has been maintaining an economic growth rate of above 7% for the past few years, the flow of exports and imports from and to China has been very active. This in turn has assisted the development of containerization in China (the rate of which now stands at less than 40%) to slowly approach the level of developed countries (above 60%). Hence, the market for container terminal operations will have a lot of upside momentum. Although it is estimated that the total new capacity to be provided by new container terminals coming into operation in the next five years is approximately 20 million TEU (out of a total of 26 million TEU being handled in China in 2001), with organic growth rate of the top ten ports averaging more than 15% annually, the threat of oversupply of capacity in China should be minimized.

Earnings, Liquidity and Financial Resources

Profit

The Group recorded a turnover of HK$1,206,100,000 for the Current Year, representing a decrease of 12.7% from the corresponding figure in 2000. Profit (including profit derived from associates and jointly controlled entities but before tax and minority interests) for the Current Year was HK$975,100,000, representing a decrease of 9.8% from that of 2000. The consolidated profit after tax and minority interests was HK$800,200,000, representing a decrease of 8.9% from the corresponding figure of HK$878,100,000 in 2000. Due to a slowdown in the global economy, especially during the second half of 2001 in which the "September 11" incident happend, the paint manufacturing business and the shipping business of the Group were adversely affected and resulted in shrinking turnover as compared with that of 2000. The decrease in the consolidated profit after tax and minority interests for the Current Year was largely due to provisions in the aggregate amount of HK$140,000,000 for impairment in the Group's interests in jointly controlled entities and the Group's investments in infrastructure joint ventures, all of which are engaged in toll road operations in China. If such provision is disregarded, the Group's consolidated profit after tax and minority interest for the Current Year will actually increase by 7% to approximately HK$940,000,000. The increase in the Group's consolidated profit after taxation and minority interests was due to additional contributions from: (i) Ming Wah Bermuda, a subsidiary in which the Group substantially increased its stake by virtue of the former's privatisation; (ii) MTL, an associated company, by way of the acquisition of an additional interest in MTL; and (iii) CIMC, another associated company, due to a continual improvement in its financial results.

The turnover and consolidated profit after tax and minority interests for ports and port-related business for the Current Year were HK$474,800,000 and HK$594,000,000, respectively, representing a 4.0% decrease from and a 11.3% increase over the corresponding figures of 2000. The promising growth in profit was largely due to the additional profit contributed by the acquisition of additional shares in MTL and the privatisation of Ming Wah Bermuda. Vigorous business growth in mainland ports invested in by the Group also contributed to such growth.

The turnover and consolidated profit after tax and minority interests for the toll road business for the Current Year were HK$29,200,000 and HK$13,800,000, respectively, representing a 5.9% decrease and a 92.0% decrease from the corresponding figures of 2000. Following the cancellation of the income guarantee arrangement in relation to the joint venture agreements of the Guiliu Expressway and the Guihuang Expressway, only the Ningzhenluo Expressway was consolidated into the Group's results. Hence, the turnover that was apportioned to the Group from the toll road business was comparatively small. The fall in profit was principally due to the fact that the guaranteed income with respect to the Zhangxia Expressway and the Zhangzhou 324 National Highway, amounting to US$8,100,000 for the Current Year, had not been paid to the Group and hence was not consolidated into the Group's results for the Current Year. The Group understands that the PRC government discourages such income guarantee arrangements and the Group has been in negotiations with the PRC joint venture partners with a view to replace the guaranteed income in the joint venture agreements with satisfactory revised profit sharing arrangements. The Company will issue a press announcement in accordance with the Listing Rules upon the conclusion of such negotiations. In light of the negative factors surrounding the toll road business, a provision of HK$140,000,000 for impairment has been provided on the toll roads during the Current Year.

The turnover and consolidated profit after tax and minority interests for industrial manufacturing business were HK$674,500,000 and HK$191,900,000, respectively, representing a respective decrease of 18.8% and 3.6% from the corresponding figures of 2000. The decrease in turnover from container manufacturing business was due to the slowdown in the global economy. However, the profit derived from the container manufacturing business still achieved satisfactory growth given the substantial number of orders received in the previous years. As a result, the consolidated profit for industrial manufacturing business ended up with only a moderate fall despite the difficult economic climate.

Working Fund and Treasury Policies

The Group's sources of funds mainly come from operating activities and returns from associates and joint ventures. Should there be a need for additional funding, the Company would look for other sources of finance such as borrowings from banks, share placings or convertible bonds, depending on the market situation. During the Current Year, the Group's free cash flow outweighed its investment needs, therefore no external funding was required. Presently, most of the free cash available is placed in fixed deposits with banks to earn risk-free interest. The Directors consider that as the Group is actively expanding its business, substantial amount of funds may be required for new investments, hence it would be appropriate to keep funds readily available in highly liquid and risk-free assets. The Group also invests in short term listed securities in order to obtain higher returns in a conservative manner.

The amount of cash and cash equivalent held by the Group in the Current Year amounted to HK$1,492,000,000, 50% of which is denominated in US Dollars ("USD"), 45% in Hong Kong Dollars ("HKD") and 5% in Renminbi ("RMB") and other currencies.

Given the level of cash on hand and working capital, the Board believes that the Group has sufficient internal funds to satisfy daily operational needs and to repay loans on schedule.

Share Capital and Financial Resources

As at 31 December 2001, the Company had issued a total of 2,053,472,388 shares. During the year, the Group received notifications for the exercise of 4,150,000 share options and received an aggregate sum of HK$21,000,000 for the issue of shares pursuant to such exercise.

The Company repurchased a total of 700,000 shares in August and September 2001, at an average price of HK$ 4.54 and for a total consideration of HK$ 3,200,000.

As at 31 December 2001, the Group carried outstanding bank loans in the amount of HK$560,000,000, of which bank loans and short-term credit facility of a term less than one year amounted to HK$270,000,000. The amount of bank loans was reduced by HK$390,000,000 from last year due to the repayment of loans during the Current Year. With regard to the bank loans, HK$220,000,000 was secured by one of the Group's vessels and the income derived from the vessel including insurance, while the remaining HK$340,000,000 was unsecured and non-guaranteed.

In addition, the balance of the convertible bonds which are due in 2004 and carry a fixed interest rate of 7% per annum amounted to HK$310,000,000. There was no conversion of the bonds during the Current Year.

The interest rate for convertible bonds is fixed and the bank loans' interest rates are floating.

The Group maintained a net cash position in the Current Year, being the same as 2000, with a gross debt ratio (total interest bearing debt divided by net assets of the Group as at 31 December 2001) of 8.0%, representing a significant improvement from the ratio of 12% of last year.

All bank loans and convertible bonds are denominated in USD. The Company does not employ any financial instrument to hedge the said loans and bonds.

Major assets of the Group are denominated in HKD, USD and RMB. The Directors consider that HKD and USD are stable currencies and the likelihood of RMB to depreciate is remote in the near future, hence no hedging instruments are used by the Group for foreign currency net investments.

Assets Pledge

As at 31 December 2001, a vessel with a net book value of HK$300,000,000 was pledged as security for the Group's banking facilities.

Contingent Liabilities

As at 31 December 2001, the Company had given guarantees for bank loans and overdrafts of subsidiaries, associates, an investee and convertible bonds in the amount of HK$420,000,000.

Employees and Remuneration

As at 31 December 2001, the Group had 700 full-time employees, of which 80 were working in Hong Kong and 620 were in the PRC. Personnel expenses amounted to HK$78,838,000 for the Current Year, representing 7.9 per cent. of the total operating expenses of the Group as at 31 December 2001. The Group undertakes review of salaries and the extent of salary increment annually, with close reference to the relevant labour market and economic situation.

The Group also provides internal training to staff and provides bonuses based upon staff performance and profits of the Company. This acts as an incentive for motivating employees to provide greater contribution to the Group. The Group has a share option scheme whereby employees of the Group may be granted options to acquire shares in the Company.

Review and future strategies

The main themes of the present strategy as employed by the Company are: to remain focused on core competencies (ports and toll roads) under professional management, to leverage on the Group's close relationship with various transport authorities so as to seek value-enhancing acquisition opportunities, and to maintain a strong financial position during such process.

Going forward, in addition to the continuous implementation of the above strategy, other plans of the Company include the consolidation of management and shareholdings for the Company's western Shenzhen ports, the future positioning of the Company's operations in Northern China through acquisitions and the strengthening of value added services such as the Container Freight Station. The implementation of all these strategies will not only reinforce the Company's position as a major operator in Southern China, but will also enable the Company to transform into a national operator, which is necessary for the attainment of economies of scale for a successful infrastructure business.

Business Strategies