Management Discussion and Analysis

Overview

SmarTone showed a strong recovery in financial performance. The Group recorded a profit attributable to shareholders of HK$115 million for 2001/02, the Group's first reported profit since 1998/99.

The turnaround from the loss in 2000/01 to profit in 2001/02 arose as follows:

* The mobile business recorded earnings before interest and tax ("EBIT") in 2001/2 of HK$105 million (2000/01-EBIT loss of HK$177 million). This substantial improvement arose due to considerably reduced cost of goods sold and other operating expenses. Costs were lower due to lower customer acquisition and retention costs and cost savings achieved through efficiency programmes.

* The Internet service provider ("ISP") business recorded a substantially reduced EBIT loss in 2001/02 of HK$82 million (2000/01-HK$311 million). This improvement resulted from both cost reduction and a lower charge for impairment of fixed assets.

Mobile

The mobile business achieved earnings before interest, tax, depreciation and amortisation ("EBITDA") for 2001/02 of HK$573 million (2000/01-HK$228 million). This arose due to lower cost of goods sold and other operating expenses. The improving trend in performance evident in the second half of 2000/01 continued throughout 2001/02. EBITDA for the second half of 2001/02 was HK$365 million (2000/01-HK$146 million) compared to HK$208 million in the first half.

Turnover decreased by HK$88 million in the year from HK$2,437 million in 2000/01 to HK$2,349 million in 2001/02. The decrease was principally due to a drop in the Group's mobile service revenue. Average ARPU for 2001/02 was HK$210 per month (2000/01-HK$213 per month). However, the year on year comparison masked a modest increase in ARPU in the second half of 2001/02. ARPU at 30 June 2002 was HK$214 (30 June 2001-HK$202). Mobile service revenue for the second half of 2001/02 rose by 9 per cent. to HK$1,130 million, compared to HK$1,041 million for the first half of the year. This was due to a higher average number of postpaid subscribers in the second half of the year.

Total subscribers of the Hong Kong mobile business was 984,000 as at 30 June 2002. Monthly churn rate in June 2002 was 3.0 per cent. compared to 5.9 per cent. in June 2001. This improvement was due to a more stable market environment and on-going retention programmes.

Cost of goods sold and services provided in 2001/02 decreased to HK$567 million (2000/01-HK$797 million). This mainly resulted from lower handset sales and a decrease in IDD costs.

Other operating expenses (excluding depreciation) decreased in 2001/02 to HK$1,209 million (2000/01-HK$1,412 million). Most categories of expense were lower due to the cost rationalisation programmes in place during the year and lower customer acquisition costs.

The Group's mobile business in Macau commenced commercial operations during the year. The business achieved positive EBITDA in the second half of 2001/02.

ISP business

During 2001/02, the restructuring of the Group's ISP business was completed. Its functional activities were absorbed into the Hong Kong mobile business to improve efficiency and reduce costs. The restructuring resulted in a much reduced operating loss before charge for impairment of fixed assets for 2001/02 of HK$14 million (2001/01-HK$175 million). EBITDA loss for 2001/02 was HK$5 million (2000/01-HK$153 million).

An additional write-down of HK$68 million (2000/01-HK$135 million) was made in the first half of the 2001/02 financial year against the carrying value of ISP fixed assets to reflect the uncertainty of this business. All fixed assets of the ISP business are now fully written down.

During the year ended 30 June 2002, the Group's performance bond obligations in respect of its LMDS licence were reduced by HK$73 million. Current outstanding performance bonds total HK$56 million. The Group expects these remaining performance bonds will be released as the associated milestones are achieved in the 2002/03 financial year.

Subsidiaries, associates and other investments

One significant wholly-owned subsidiary, SmarTone 3G Limited, was established during the year to acquire the Group's 3G licence in Hong Kong.

The Group has invested in three telecom and technology venture capital funds, one of which is held via an investment in an associated company. During the year ended 30 June 2002, a provision of HK$26 million was made against these funds to reflect their current estimated market valuation. The Directors are of the opinion these investments are now conservatively valued.

There were no disposals of subsidiaries, associates or other investments during the year ended 30 June 2002.

Capital structure, liquidity and financial resources

The Group is financed entirely by share capital and internally generated funds and has no external borrowings. The cash reserves of the Group remain strong with cash and bank balances and fixed income investments of HK$3,587 million as at 30 June 2002, an increase of HK$108 million during 2001/02. During the year, the Group invested HK$643 million in held-to-maturity investment grade fixed income securities to generate a better rate of return on its surplus cash.

The Group had a net cash inflow from operating activities during the year of HK$387 million. Interest received during the year was HK$75 million compared to HK$207 million in the previous financial year mainly due to the lower market interest rates prevailing during the year. In addition to the purchase of fixed income investments, the Group's other major outflows of funds during the year were purchase of fixed assets and purchase of its own shares.

The Directors are of the opinion that the Group can fund its capital expenditure for the current financial year ending 30 June 2003 from existing cash resources.

Treasury policy

The Group invests its surplus funds in accordance with a treasury policy approved from time to time by the Board of Directors. Surplus funds are placed on deposit with banks in Hong Kong or invested in investment grade debt securities. Bank deposits in Hong Kong are maintained materially in Hong Kong dollars.

The Group's investments in debt securities are denominated in either Hong Kong or United States dollars with a maximum maturity of 3 years. The Group's policy is to hold its investments in debt securities until maturity.

The Group is required to arrange for banks to issue performance bonds and letters of credit on its behalf. In certain circumstances, the Group will partially or fully collaterise such instruments by cash deposits to lower their issuance cost. Total amount of pledged deposits at 30 June 2002 was HK$525 million (30 June 2001-HK$134 million).

Functional currency and foreign exchange exposure

The functional currency of the Group is the Hong Kong dollar and all material revenues, expenses, assets and liabilities are denominated in Hong Kong dollars. The Group does not therefore have any significant exposure to gains or losses arising from the movement of foreign exchange rates against the Hong Kong dollar. It does not currently undertake any foreign exchange hedging activity.

Contingent liabilities

* *Performance bonds*

Certain banks, on the Group's behalf, have issued performance bonds to the telecommunications authorities of Hong Kong and Macau in respect of obligations under licences issued by those authorities. The total amount outstanding at 30 June 2002 under these performance bonds was HK$308 million (30 June 2001-HK$131 million). All performance bonds were fully cash collaterialised using surplus cash deposits. The increase arose due to the HK$250 million performance bond issued to the telecommunications authority of Hong Kong in respect of its 3G licence acquired during the year offset by fulfilment of certain milestone obligations in respect of its LMDS business licence and release of the related bonds.

* *Lease out, lease back arrangement*

A bank, on the Group's behalf, had issued a letter of credit to guarantee the Group's obligations under a lease out, lease back arrangement entered into during the year ended 30 June 1999. During the year ended 30 June 2002, this letter of credit was renewed with the bank on a fully cash collaterialised basis. The Directors are of the opinion that the risk of the Group being required to make payment under this guarantee is remote.

Other than the above, the Group has no other material contingent liabilities.

Employees and share option scheme

The Group employed approximately 1,200 full-time employees as at 30 June 2002, with the majority in Hong Kong. Staff receive a remuneration package consisting of basic salary, incentive bonus and other benefits. Bonus payments are discretionary and depend, inter-alia, on both the Group's performance and the performance of the individual employee. Benefits include a mandatory provident fund scheme and medical and dental care insurance. Staff members are provided with both internal and external training appropriate to each individual's requirements.

The Group has a share option scheme, full details of which are included in the Report of the Directors.