management's discussion and analysis of financial condition and results of operations

The following discussion is based on, and should be read in conjunction with, the financial statements and the notes thereto included elsewhere in the annual report.

General

The Group is the fourth largest cruise line in the world by lower berths with 20 ships and over 26,000 lower berths under three mainstream brand names, Star Cruises, Norwegian Cruise Line and Orient Lines. Star Cruises and Cruise Ferries operate nine ships offering various cruise itineraries and calls destinations primarily in the Asia Pacific region. Norwegian Cruise Line and Orient Lines operate eleven cruise ships including Norwegian Dawn in the Caribbean, Bermuda, Alaska, Europe, Hawaii, New England, Central and South America. In December 2002, Norwegian Cruise Line took delivery of the Norwegian Dawn which is presently offering Eastern and Western Caribbean cruises.

Revenues from Cruise and Cruise-related Activities

Revenues from cruise and cruise-related activities can be further categorised as "cruise revenues" and "on-board revenues". Cruise revenues are derived from the sale of passenger tickets. Passenger ticket sales comprise a one-off up-front payment collected from passengers for accommodation, meals in certain restaurants on the ship, certain on-board entertainment and, where relevant, air and land transportation to and from the ship. Passenger ticket sales also includes amounts collected as passenger handling charges, which are charged to the passengers separately from the price of passenger tickets, but which are recorded as passenger ticket sales. These passenger handling charges include port fees, berthing charges, embarkation and disembarkation fees, baggage handling charges and other related charges. Revenues from passenger ticket sales are collected from passengers prior to their departure on the cruise, usually at the time of booking the cruise.

On-board revenues consist of revenues from gaming, beverage sales, shore excursions, a la carte dining outlets and revenues from on-board retail sales. On-board revenues vary according to the size of the ships in operation, the length of cruises operated, and the markets in which the ships operate.

Charter-hire Revenues

The Group derived revenues from the bareboat charter-hire of a catamaran to a third party customer. The revenues the Group derived from charter-hire generally vary according to the number of ships it has on charter-hire during a given period.

Operating Expenses

Operating expenses are made up of air and land transportation expenses, overnight shoreside hotel expenses, passenger transfer costs, travel agent commission, ship charter costs and all shipboard operating expenses including crew wages and benefits, port charges, fuel, food, ship maintenance and entertainment expenses, cabin consumables, ship insurance and charter-hire expenses. Most of the operating expenses are generally fixed per cruise, while passenger food expenses and port expenses typically vary according to the number of passengers on board a particular cruise ship.

Selling, General and Administrative Expenses

Selling expenses consist of the expenses of the Group's marketing activities. These marketing activities include advertising and promotional activities, operation of the Group reservation call centres and support functions, and other passenger related services.

General and administrative expenses consist of shoreside personnel wages and benefits, and expenses relating to the Group's world-wide offices, information technology support, crew training and support (including the operation of the Star Cruises Ship Simulator Centre), purchasing operations and other ship-related support activities.

Depreciation and Amortisation

Depreciation and amortisation expenses consisted primarily of depreciation of ships and shoreside assets as well as amortisation of goodwill and trade names and trademarks.

Foreign Exchange and Interest Rate Swaps

The functional currency of the Group is the U.S. dollar as a substantial portion of the Group's transactions are realised or settled in U.S. dollars. Transactions in currencies other than U.S. dollars ("foreign currencies") are translated into U.S. dollars at exchange rates in effect at the transaction dates. Monetary assets and liabilities expressed in foreign currencies are translated at exchange rates at the balance sheet date. All such exchange differences are reflected in the consolidated profit and loss account.

The Group does not undertake extensive hedging of its foreign currency cashflows as the Directors believe that the main foreign currencies in which the Group derives its revenues, the Singapore dollar and the Hong Kong dollar, are generally stable. The Group does from time to time enter into hedging arrangements in connection with anticipated foreign currency fluctuations against the U.S. dollar. At present, the Group is a party to certain forward contracts with a total notional amount of US$206.7 million in respect of the Singapore dollars and US$60.7 million in respect of the Hong Kong dollars. These forward contracts have remaining life ranging from 3 to 9 years.

The Group's indebtedness and its related interest expenses are denominated in U.S. dollars and are based upon floating rates of interest. In order to limit its exposure in interest rate fluctuation, variable to fixed interest rate swaps have been utilised from time to time, to fix a portion of interest costs over a period of time. The Group continuously evaluates its debt portfolio, including interest rate swaps to achieve a desired proportion of variable and fixed debt based on its view of interest rate movement. As at 31 December 2002, the Group had interest rate swaps on debts with a notional amount of US$430.4 million with remaining lives ranging from 5 to 9 years.

Taxation

Bermuda, the jurisdiction for Star Cruises Limited ("the Company"), and certain of its subsidiaries together with the Isle of Man, the jurisdiction of incorporation for most of the Company's other operating subsidiaries, impose no tax on income derived outside of those respective jurisdictions. The Company's operating subsidiaries do, however, file relevant returns in the tax regimes of the relevant jurisdictions in which they operate, and pay taxes as required by those regimes. Income tax expense includes current taxes and the change in deferred taxes. Deferred tax assets and liabilities are calculated in accordance with the liability method.

Seasonality

The cruise industry in Asia Pacific is less seasonal than the North American cruise market. This lower degree of seasonality is primarily attributable to the lower degree of seasonal climate variation in certain parts of Asia Pacific, particularly South East Asia. However, the Group has generally experienced a decrease in demand in December and January in the Hong Kong market attributable to unfavourable weather patterns during that time of year. This seasonal decrease in demand is generally offset by increased demand in other markets, such as Singapore, Thailand, and Malaysia, related to public holidays in December and January.

The cruise industry in North America is, however, moderately seasonal with greater demand generally occurring during the months of December through March and June through August.

Demand, however, also varies by ship and itinerary.

Human Resources

As at 31 December 2002, the Group had approximately 16,778 full time employees, of which approximately 14,250 were ship officers, crew and staff on ships. The remaining were employed in shoreside operations world-wide. The Group has provided employee benefits including provident fund scheme and medical insurance schemes for its staff.

The Group has a Post-listing Employees' Share Option Scheme, under which options may be granted to employees of the Group entitling them to subscribe for shares of the issued and paid up share capital of the Company from time to time. On 19 August 2002, the Company offered options entitling the Directors of the Company and employees of the Group to subscribe for an aggregate of 100,269,000 ordinary shares at the subscription price of HK$3.20 (US$0.41) per ordinary share under the Post-listing Employees' Share Option Scheme.

There is no significant change in the remuneration policies; bonus and share options schemes and training schemes for the Group during the year ended 31 December 2002, except that the Post-listing Employees' Share Option Scheme was amended on 22 May 2002 to comply with the new requirements of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules").

Results for the year ended 31 December 2002 as compared with the year ended 31 December 2001

Turnover

The Group's revenue for the year ended 31 December 2002 was US$1,573.6 million, up 13.9% from US$1,381.6 million for the year ended 31 December 2001. During the year ended 31 December 2002, capacity increased 13.5% due primarily to the full year operations of M/S Norwegian Sun, m.v. Norwegian Star, Wasa Queen and SuperStar Capricorn. The introduction into service of m.v. Norwegian Dawn in December 2002 also contributed to the increased capacity. Net yield, defined as net revenue per capacity day after deducting such costs as commission, air tickets and other direct costs was 1.7% lower.

Star Cruises Asia Pacific operated with 11.0% less capacity days in the year ended 31 December 2002 compared to the year ended 31 December 2001. The decline in capacity days was primarily due to the return of chartered ships, SuperStar Taurus and Norwegian Star 1 in the first half of 2002 and the disposal of Star Aquarius, MegaStar Sagittarius and MegaStar Capricorn in the first quarter of 2001. This was partially offset by the introduction of Wasa Queen in September 2001 and the rejoining of SuperStar Capricorn into the fleet in January 2002. In November 2001, the Group received an amount of approximately US$5 million upon termination of the charter-hire of SuperStar Capricorn. Net yield in year 2002 decreased 0.7% as compared with year 2001.

NCL Group (which consists of Norwegian Cruise Line and Orient Lines brands) recorded an increase in capacity days of 29.0% for year 2002 as compared to year 2001. The increase in capacity days was primarily due to the full year operations of M/S Norwegian Sun and m.v. Norwegian Star. Net yield in 2002 was essentially the same as compared with year 2001.

Cost and expenses

Total costs and expenses before interest and non-operating items for the year ended 31 December 2002 amounted to US$1,412.7 million as compared with US$1,297.0 million for the year ended 31 December 2001. The comparison with 2001 is affected by the inclusion of non-recurring charges in both years 2002 and 2001. The Group incurred US$3.6 million of non-recurring charges in year 2002. The costs and expenses of 2001 included non-recurring charges of US$30.8 million and a fixed asset impairment loss of US$8.4 million related to a write down in the carrying value of a ship.

Non-recurring charges in year 2002 primarily consisted of the results of the binding arbitration settlement relating to the redelivery of the M/S Leeward, including additional legal and lease expenses. These expenses are net of amounts received related to the early redelivery of the M/S Norwegian Star 1.

Non-recurring charges in year 2001 were mainly expenses in rationalising the North Asia operations, with the cessation of cruise operations in Taiwan and Japan.

Excluding these non-recurring expenses, total costs and expenses before interest and non-operating items increased US$151.4 million from US$1,257.8 million for the year ended 31 December 2001 to US$1,409.2 million for the year 2002.

Cost and expenses *(continued)*

Operating expenses before non-recurring expenses increased US$128.9 million from US$862.4 million for year 2001 to US$991.3 million in year 2002. Ship operating expenses (excluding costs such as commissions, air tickets and other direct costs as they are already factored into the net yield) before fuel costs was, however, 5.4% lower on a per capacity day basis for the year ended 31 December 2002 as compared with year 2001. The ship operating expenses on a per capacity day basis dropped mainly attributable to the savings from cost control initiatives implemented in 2001, and the rationalisation of its cruise operations in November 2001 following the 11 September events.

Selling, general and administrative expenses before non-recurring expenses also reduced on a per capacity day basis for the year ended 31 December 2002 as compared with year 2001 as the Group continued to enjoy the benefits from the economies of scale from the increased capacity. The merging of shoreside operations of Orient Lines and NCL coupled with cost control measures drove the selling, general and administrative costs before non-recurring expenses down by 11.6% on a per capacity day basis in the year 2002 against the year 2001.

Depreciation and amortisation expenses increased US$21.8 million from US$154.4 million for the year ended 31 December 2001 to US$176.2 million for the year ended 31 December 2002. The increase was primarily due to additional depreciation associated with the Norwegian Sun and Norwegian Star and ship refurbishment expenditure during the year.

Operating profit

The Group recorded an operating profit of US$160.8 million for the year ended 31 December 2002 as compared with US$84.5 million in 2001. Excluding non-recurring expenses and fixed assets impairment loss as well as the proceeds from early termination of a ship charter ("the net non-recurring expenses"), operating profit for 2002 would be US$164.4 million as compared with US$118.8 million for 2001.

Non-operating income/(expense)

Non-operating expenses was higher by 9.7% to US$108.4 million for the year ended 31 December 2002 as compared with US$98.8 million in year 2001. In 2002, the Group has a non-cash loss on foreign exchange amounted to US$3.0 million as compared to a non-cash gain on foreign exchange of US$14.6 million recorded in year 2001. The non-cash foreign exchange loss in 2002 was primarily due to the strengthening of the Singapore dollar against the US dollar during the year. The Group also recorded losses on extinguishment of debts of approximately US$5.9 million in the year ended 31 December 2002. Net interest expenses for the year ended 31 December 2002 reduced compared with 2001 as the Group benefited from the lower interest rate.

Profit before taxation

The Group recorded profit before taxation of US$52.4 million in the year ended 31 December 2002 as compared to a loss before taxation of US$14.3 million for the year ended 31 December 2001. Excluding the net non-recurring expenses, the non-cash gain/(loss) on foreign exchange and the losses on extinguishment of debts, the profit before taxation for 2002 would be US$64.9 million as compared with a profit before taxation of US$5.3 million for 2001.

Taxation

The Group incurred taxation expenses of US$1.5 million in 2002 as compared with US$1.8 million in 2001.

Net profit attributable to shareholders

With a 13.5% higher capacity and a higher occupancy at 98%, as well as a lower cost structure during the year, net profit attributable to shareholders increased significantly from a loss of US$16.0 million for the year 2001 to US$50.9 million for year 2002. Excluding net non-recurring expenses, the non-cash gain/(loss) on foreign exchange and losses on extinguishment of debts, the net profit attributable to shareholders for year 2002 would be US$63.4 million as compared with a net profit US$3.6 million in year 2001.

Liquidity and capital resources

Sources and uses of funds

The majority of the cash and cash equivalents are held in U.S. dollars. The Group's business provided US$275.9 million of net cash from operations for the year ended 31 December 2002 as compared to US$180.2 million for the year ended 31 December 2001.

During the year ended 31 December 2002, the Group's capital expenditure was approximately US$420.6 million. Approximately US$355.2 million was related to the delivery of m.v. Norwegian Dawn and payments for the incomplete Project America hulls and certain related materials. The remaining balance was mainly for vessel refurbishing and shore side assets.

In March 2002, the Group refinanced the outstanding balance of the 5-year syndicated term loan through a drawndown of US$450 million syndicated term loan. The Group also made scheduled principal repayments of US$94.6 million in relation to its long-term bank loans during the year ended 31 December 2002.

Upon the delivery of m.v. Norwegian Dawn on 3 December 2002, the Group drewdown US$313.5 million under a syndicated term loan agreement obtained in 1999, which was amended to provide for borrowings up to US$626.9 million in October 2001, to pay the shipyard.

In June 2002, the Group issued approximately 189 million new ordinary shares of US$0.10 each at the price of HK$3.30 (US$0.42) per share to an existing shareholder in a top-up share placement. The net proceeds of approximately US$77.3 million will be used as general working capital and for the acquisition or construction of vessel(s).

In December 2002, the Group issued approximately 607.4 million rights shares of US$0.10 each in the proportion of 7 rights shares for every 50 shares held at HK$1.95 (US$0.25) per rights share. The net proceeds of approximately US$150.3 million will be used for the acquisition or construction of vessel(s) and as general working capital.

During the last quarter of 2002, the restricted cash increased by approximately US$48.9 million mainly as a result of a requirement imposed by Norwegian Cruise Line Limited's ("NCLL") bank card processor.

Cash and cash equivalents increased to US$417.0 million as at 31 December 2002 from US$171.6 million as at 31 December 2001.

Gearing ratio

The gearing ratio as at 31 December 2002 was 0.51 times as compared with 0.53 times as at 31 December 2001. The calculation of gearing ratio is based on total outstanding borrowings of the Group of US$2,434.0 million (2001: US$2,215.1 million) divided by the total assets at the end of the year of US$4,758.7 million (2001: US$4,219.0 million).

As a result of share issues and net cash generated from operations during the year, as well as changes in the outstanding debt balances, the gearing ratio has reduced slightly to 0.51 from 0.53.

Contingent liabilities
Details of the contingent liabilities of the Group as at 31 December 2002 are disclosed in note 27 to the accounts.

Future commitments and funding sources
As at 31 December 2002, the Group has approximately US$2.4 billion of bank borrowings outstanding of which approximately US$340.2 million is due in 2003. Details of bank borrowings and a schedule setting out the repayments of such borrowings are disclosed in note 21 to the accounts. These outstanding bank borrowings are secured by legal charges over vessels including fixed and floating charges over assets of the Group of US$3.1 billion and guarantees given by the Group.

NCLL, a Group subsidiary that owns and operates nine of the Group's ships, has a sizeable funding requirement during 2003 that will require support from the Group. Loan repayments, together with collateral requirements in connection with entering into a new credit card processor relationship, amount to US$351 million, with US$143 million of this figure due in December 2003. It is expected that US$100 million of the total figures will be met by issuance of a letter of credit to be obtained by Star Cruises. The balance is expected to be met by a combination of cash flow from operations and funding from Star Cruises.

The Group generally needs approval from its bankers before advancing funds to its major US-based subsidiaries. In this instance Star's bankers have consented to the obtaining of a letter of credit, and have issued a preliminary consent to the infusion of additional cash into Arrasas Limited (the immediate holding company of NCLL).

The Group's Directors are confident that the Group has various options to fund NCLL and has sufficient cash reserves to assist, as necessary, in meeting all NCLL obligations.

The Group believes that its cash and cash equivalents of approximately US$417.0 million as at 31 December 2002 as well as its forecasted cash flow from future operations, will be sufficient to fund its capital projects, debt service requirements, working capital and other firm commitments.