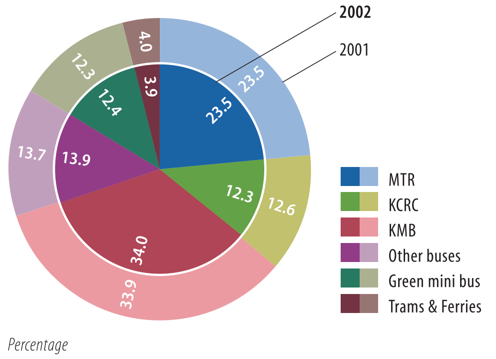
Executive management's report

business environment



Market shares of major transport operators in HK
Despite competition from buses, MTR maintained its share of the Hong Kong transport market at 23.5%, as the Tseung Kwan O Line boosted patronage.

Recovery postponed

Following the anemic growth and poor financial market performance of the previous two years, 2002 began with great anticipation of a significant turnaround in both the world economy and financial markets. In the event, the year was another disappointment. A series of shocks to the economic system, from accounting and corporate governance scandals in the United States, to terrorist attacks in various parts of the world and escalating tension between Iraq and the United States, badly undermined confidence. Major stock indices around the world fell sharply, investor sentiment and business investment remained weak, and consumers reined in spending.

Hong Kong's open economy was affected by these global events. In addition, the SAR continued to suffer the effects of a structural adjustment unleashed by the bursting of its own asset bubbles, as well as China's rapid industrialisation and integration into the world economy. Deflation remained a major threat to the economy as asset prices continued to decline. Average residential property prices fell another 6% and the *Hang Seng Index* finished the year 18% lower at 9,321. Consumer prices remained on the downtrend, bringing Hong Kong into its fourth consecutive year of deflation. Unemployment rose to 7.8%, its highest level since 1981. Against this backdrop, both consumer demand and investment growth were weak, in spite of ample liquidity in the banking system and record low interest rates.

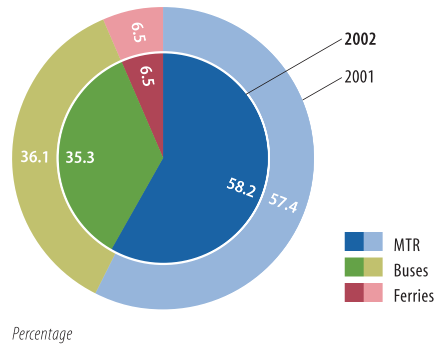
External demand was the only bright spot in the economy in 2002 as Hong Kong benefited from China's impressive economic performance and export growth. Hong Kong's role as a logistics hub for southern China led to strong increases in air cargo volumes and container throughput, with exports and re-exports registering a combined growth of 5.4% for the year. Tourism was also boosted by larger numbers of visitors from Mainland China. As a result, despite continuing weak internal demand and consumption, Hong Kong managed to register GDP growth of 2.3% for 2002, better than the 0.6% recorded in 2001.

Transport

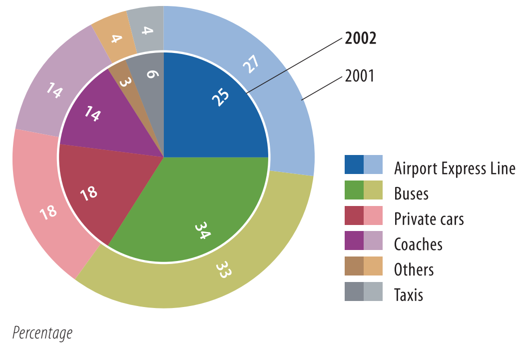
After modest growth of 1.5% in 2001, the franchised public transport industry posted a 2.1% increase in 2002.

Total public transport demand for the year was 4,083 million journeys, up from 4,017 million in 2001, of which franchised operators including MTR, KCRC, buses, green mini-buses, trams and ferries, carried 3,347 million. Despite the weak economy and continued strong competition from other modes of transport, MTR's market share was maintained at 23.5% following the opening of the Tseung Kwan O Line.

Overseas tourist arrivals increased by a healthy 20.7% to 16.6 million. This was largely due to a 53.4% surge in visitors from Mainland China following the ending of a daily quota system in January 2001. Air passenger traffic rose 2% to 23.5 million. The market share of the Airport Express Line fell marginally from 27% to 25%, however, due to the elimination of the 10% fare discount.



Market shares of transport operators crossing the harbour
Speed, comfort, affordability and reliability continued to make MTR by far the preferred public mode of crossing the harbour.



Market shares of transport operators to/from the airport
Discontinuation of fare discounts led, as expected, to a moderate decline in market share of the Airport Express Line.

The Government's commitment to improving Hong Kong's transport infrastructure and quality of life through expansion of the rail network was unchanged. This includes the target, as outlined in its Railway Development Strategy 2000 report, of bringing 70% of the population within one kilometre of a railway station and raising railway's share of public transport from 31% in 2000 to 43% by 2016.

Such services will undoubtedly be welcomed by the travelling public, given railway's speed, safety and reliability. Hong Kong's population is forecast by the Government to grow from the present 6.8 million to 7.5 million by 2011. Much of the increase is expected to come from immigration from Mainland China, a demographic that suggests a concentration of increase in urban areas and newer towns such as Tung Chung.

Property

The shocks to the economic system reverberated through Hong Kong's property sector. Prices and rentals continued their downward adjustment.

In the office sector, demand remained weak as sharply lower business volumes led financial services firms to cut back on space requirements. Leasing activity was very subdued, with little external demand for new space and companies reluctant to incur relocation costs. New supply added to downward pressure on rents, which fell substantially during the year. The retail sector continued to suffer the effects of a poor economy and an outflow of shoppers to the Mainland.

The residential market was affected by worsening sentiment and an overhang of supply, which overshadowed both lower interest rates and a number of Government initiatives to support the market. For the year, the value of unit transactions decreased by 3.8% from 2001 to HK$185 billion, marking a 12-year low. Activity was driven by the primary market, as developers competed to offload inventory through aggressive price discounts and attractive financing packages.

The Government's new housing policy, announced in November, has as its core intention that the market should be regulated by market forces and officially puts an end to the 70% home ownership target set by the Administration in 1997. It includes the suspension in 2003 of land auctions and of development tenders by Hong Kong's railway companies.

Despite this, little improvement is expected in the property sector in the near term. The office sector will need to see business volumes in the financial services sector rise from their current depressed levels before the downward trend reverses. Firm evidence of brighter employment and earnings prospects is required before positive sentiment returns to the residential market. The retail sector may, however, see some improvement, as the price differential between Hong Kong and Shenzhen narrows.