Management's Discussion and Analysis

Overview

- **EBITDA[1] increased 10 percent to HK$8,120 million (approximately US$1,041 million)**
- **EBITDA margin increased from 34 percent to 40 percent**
- **Operating profit before net gains on investments, provision for impairment losses and restructuring costs increased 9 percent to HK$5,212 million (approximately US$668 million)**
- **Operating cash flow after interest, taxes and capital expenditure (but before investment in Cyberport) increased 54 percent to HK$3,351 million (approximately US$430 million)**
- **Net Debt[2] decreased 16 percent to HK$32,919 million (approximately US$4,220 million)**
- **Difficult but prudent decisions taken on a HK$8,263 million (approximately US$1,059 million) impairment loss for investment in Reach Ltd. (REACH)**
- **Management's Discussion and Analysis compiled as of March 20, 2003.**

The consolidated revenue of the Group was HK$20,112 million (approximately US$2,578 million) and EBITDA was HK$8,120 million (approximately US$1,041 million) for the year ended December 31, 2002, compared to revenue of HK$21,959 million (approximately US$2,815 million) and EBITDA of HK$7,396 million (approximately US$948 million), respectively, for the year ended December 31, 2001. Operating profit before net gains on investments, provision for impairment losses and restructuring costs increased 9 percent to HK$5,212 million (approximately US$668 million). Loss attributable to shareholders for the year was HK$7,762 million (approximately US$995 million), compared to a restated net profit of HK$1,343 million (approximately US$172 million) the previous year.

The largest part of the decrease in consolidated revenue is attributable to the significant reduction in one-off revenue from Cyberport entrustment fees and from property sales of HK$83 million (approximately US$11 million) in 2002 compared to HK$922 million (approximately US$118 million) in 2001. The remaining recurring revenue of HK$20,029 million (approximately US$2,568 million) in 2002 decreased by 5 percent from HK$21,037 million (approximately US$2,697 million) in 2001 primarily due to the significant downward pricing pressure in international telecommunications markets; reduction in the overall number of direct exchange lines in service; and the Company's conscious decision to reduce its low-margin computer and customer premises equipment ("CPE") sales business. However, continuing strong growth in broadband and Business eSolutions revenue has partially offset these revenue declines.

Against the backdrop of a softening economy and a challenging operating environment, demand for broadband Internet products and services continued to be strong during the year. The number of total broadband access lines provided by PCCW increased significantly by 39 percent to approximately 559,000. Business eSolutions revenue increased by 15 percent year-on-year to HK$2,234 million (approximately US$286 million) and contributed a significant 11 percent to Group revenue, compared to 9 percent a year ago.

Group EBITDA for the year ended December 31, 2002 was HK$8,120 million (approximately US$1,041 million), an increase of approximately 10 percent year-on-year. Group EBITDA margin expanded to approximately 40 percent for the year of 2002, compared to 34 percent in 2001. The substantial improvement in EBITDA margin was primarily driven by cost savings from the restructuring of the Group's Internet Services business, reduction in wholesale international traffic disbursements, overall productivity improvements in operating costs and more cautious control on corporate overheads; and the significant reduction in one-off, low-margin Cyberport entrustment fees and property sales in the current year.

Operating profit before net gains on investments, provision for impairment losses and restructuring costs also increased in line with Group EBITDA, or 9 percent to HK$5,212 million (approximately US$668 million) for the year ended December 31, 2002 from HK$4,774 million (approximately US$612 million) for the year ended December 31, 2001.

Net profit for the year ended December 31, 2002 before non-recurring items comprising impairment loss for goodwill attributable to the Group's interest in REACH; accounting loss on the disposal of the Group's 40 percent interest in Joint Venture (Bermuda) No. 2 Limited ("RWC"); profit on disposal of the Group's partial interest in MobileOne Ltd. ("MobileOne"); and restructuring costs was HK$2,245 million (approximately US$288 million), an increase of 67 percent compared to the restated net profit of HK$1,343 million (approximately US$172 million) in 2001. Profit attributable to shareholders for the year ended December 31, 2001 was restated as a result of the retrospective restatement of the prior year's taxation balance to take into account a change in the accounting standard on income taxes, as a result of the adoption of Statement of Standard Accounting Practice ("SSAP") No. 12, issued by the Hong Kong Society of Accountants with effect from January 1, 2002.

The shift to a substantial loss attributable to shareholders of HK$7,762 million (approximately US$995 million) for the year ended December 31, 2002 from the restated net profit of HK$1,343 million (approximately US$172 million) for the year ended December 31, 2001 is largely a result of an impairment loss recognized for the goodwill in relation to the Group's investment in REACH, amounting to approximately HK$8,263 million (approximately US$1,059 million). In addition, an accounting loss of approximately HK$1,771 million (approximately US$227 million) was also created following the disposal of the Group's 40 percent interest in RWC. These accounting losses are mainly a result of the inclusion of goodwill previously eliminated against reserves in the current year's impairment provision and in the cost of disposal. The accounting treatment has no impact on the Group's operations, cash flows, revenue, profit from operations or EBITDA.

The Group's businesses generated strong cash flow. Operating cash flow after interest, taxes and capital expenditure, but before investment in the Cyberport development, increased by 54 percent to HK$3,351 million (approximately US$430 million) for the year ended December 31, 2002. This was the result of a robust cash flow generated by the core telecommunications business, lower net interest payments and a reduction in capital expenditure during the year.

PCCW continued its refinancing strategies and further de-leveraged during the year, reducing Net Debt by approximately 16 percent from HK$39,305 million (approximately US$5,039 million) in 2001 to HK$32,919 million (approximately US$4,220 million) by the end of 2002. The Group has also taken measures to reduce the interest costs on its borrowing, despite a significant program of lengthening maturities. Average cost of debt declined from 6.6 percent to 5.0 percent year-on-year.

During the year, PCCW took significant steps in its strategic realignment plans. Those steps included: (i) establishing a subcontracting program, under which approximately 1,600 employees in network maintenance and installation divisions were offered the opportunity to form their own independent companies which then signed agreements with PCCW to provide services to PCCW; and (ii) forming a new wholly-owned subsidiary, Cascade Limited ("Cascade"), one of Hong Kong's largest technical services companies which will also continue to provide PCCW's telecommunications network operations, support and maintenance services. As part of the formation of Cascade, approximately 3,000 employees accepted new service contracts that generally reduced salaries slightly, as well as to realign benefit packages. Subject to contractual agreements with PCCW, the subcontracting companies and Cascade are free to pursue new business opportunities in Hong Kong and throughout Asia Pacific. During the year, the Group also reset staff levels for maximum efficiency and further streamlined operations.

1 EBITDA represents earnings before interest, taxation, depreciation, amortization, loss on disposal of fixed assets, net gains on investments, provision for impairment losses, restructuring costs, impairment loss for goodwill attributable to the interest in REACH, net losses on disposal of interests in RWC and MobileOne, other income and the Group's share of results of associates, jointly controlled companies and unconsolidated subsidiaries. While EBITDA is commonly used in the telecommunications industry worldwide as an indicator of operating performance, leverage and liquidity, it is not presented as a measure of operating performance in accordance with generally accepted accounting principles in Hong Kong and should not be considered as representing net cash flows from operating activities. The computation of the Group's EBITDA may not be comparable to similarly titled measures of other companies.

2 Net Debt refers to long-term liabilities plus short-term borrowings, minus cash and cash equivalents, and fixed deposits placed for banking facilities for the Cyberport project.

Audited Consolidated Results

For the year ended December 31, 2002

(Amounts expressed in millions of Hong Kong dollars except for (loss)/earnings per share)	2002	2001 (Restated)
Turnover	**20,112**	21,959
Operating profit before net gains on investments, provision for impairment losses and restructuring costs	**5,212**	4,774
Gains on investments, net	**13**	767
Provision for impairment losses	**(534)**	(91)
Restructuring costs	**(311)**	–
Profit from operations	**4,380**	5,450
Finance costs, net	**(1,997)**	(3,056)
Share of results of jointly controlled companies	**550**	523
Share of results of associates	**281**	158
Share of results of unconsolidated subsidiaries	–	152
Impairment loss for goodwill attributable to the interest in REACH	**(8,263)**	–
Losses on disposal of interests in RWC and MobileOne, net	**(1,433)**	–
(Loss)/Profit before taxation	**(6,482)**	3,227
Taxation, as previously stated	**(1,406)**	(1,433)
Prior period adjustment arising from adoption of new accounting standard for deferred taxation	–	(549)
Taxation, as restated	**(1,406)**	(1,982)
(Loss)/Profit after taxation	**(7,888)**	1,245
Minority interests	**126**	98
(Loss)/Profit for the year attributable to shareholders	**(7,762)**	1,343
Basic (loss)/earnings per share	**(168.53 cents)**	30.01 cents
Diluted earnings per share	**N/A**	29.11 cents

Condensed Consolidated Balance Sheet

At December 31

HK$ million	2002	2001 (Restated)
Total assets	**49,763**	51,841
Total liabilities	**(55,271)**	(62,338)
Net Liabilities	**(5,508)**	(10,497)
Represented by:		
Share capital	**1,164**	1,135
Deficit	**(7,080)**	(12,176)
Minority interests	**408**	544
Net Liabilities	**(5,508)**	(10,497)

Financial Information and Operating Performance of Business Unit

Group Structure

The Group's business comprises the following main areas:

- Telecommunications Services ("TSS") is the leading provider of telecommunications services, Internet access and multimedia services and equipment businesses in Hong Kong;

- Business eSolutions offers IT solutions, business broadband Internet access, hosting and facilities management services and yellow pages businesses within Hong Kong and Greater China;

- Infrastructure covers the Group's property portfolio in Hong Kong and Greater China including the Cyberport development in Hong Kong; and

- Others. Through a strategic alliance with Telstra Corporation Limited ("Telstra"), the Company owns 50 percent of REACH, which offers international connectivity services primarily within the Asia region. Also included in the Group's other businesses are its Greater China businesses, Pacific Century CyberWorks Japan Co., Ltd. ("PCCW Japan"), Internet Services and CyberWorks Ventures.

Financial Review of Business Units

(Excluding REACH)

Year ended December 31

	2002				2001[1]				y-o-y
	H1 HK$ million	H2 HK$ million	Full Year HK$ million	Full Year US$ million	H1 HK$ million	H2 HK$ million	Full Year HK$ million	Full Year US$ Million	Increase/ (Decrease)
Revenue									
TSS*	**9,105**	**8,902**	**18,007**	**2,309**	9,983	9,844	19,827	2,542	(9)%
Business eSolutions‡	**1,142**	**1,092**	**2,234**	**286**	986	950	1,936	248	15%
Infrastructure	**311**	**374**	**685**	**88**	721	647	1,368	175	(50)%
Others†	**362**	**431**	**793**	**102**	263	205	468	60	70%
Eliminations	**(717)**	**(890)**	**(1,607)**	**(207)**	(641)	(999)	(1,640)	(210)	2%
Total Revenue	**10,203**	**9,909**	**20,112**	**2,578**	11,312	10,647	21,959	2,815	(8)%
EBITDA									
TSS*	**4,487**	**4,416**	**8,903**	**1,142**	4,737	4,514	9,251	1,186	(4)%
Business eSolutions‡	**125**	**26**	**151**	**19**	69	(6)	63	8	140%
Infrastructure	**279**	**197**	**476**	**61**	310	256	566	73	(16)%
Others†	**(760)**	**(650)**	**(1,410)**	**(181)**	(1,205)	(1,279)	(2,484)	(319)	43%
Total EBITDA	**4,131**	**3,989**	**8,120**	**1,041**	3,911	3,485	7,396	948	10%
EBITDA Margin	**40%**	**40%**	**40%**	**40%**	35%	33%	34%	34%	
Depreciation and amortization	**(1,403)**	**(1,429)**	**(2,832)**	**(363)**	(1,312)	(1,251)	(2,563)	(329)	10%
Loss on disposal of fixed assets	**(4)**	**(72)**	**(76)**	**(10)**	(7)	(56)	(63)	(8)	21%
Others	–	–	–	–	31	(27)	4	1	(100)%
Operating Profit[2]	**2,724**	**2,488**	**5,212**	**668**	2,623	2,151	4,774	612	9%

Notes:

1 Comparative figures were restated to conform with current year's classification as follows:

* Retail consumer broadband and narrowband Internet access services and related multimedia services were transferred to TSS from Internet Services in 2002.

† The remainder of Internet Services, which primarily comprises costs associated with the production of English and Chinese Internet and broadband content, is included under Others in 2002.

‡ The operations of Internet Data Centers were merged into and are reported under Business eSolutions in 2002.

2 Operating profit before net gains on investments, provision for impairment losses and restructuring costs.

Revenue by Business Units

Telecommunications Services ("TSS")

During 2002, TSS continued to actively manage its business and operations in response to the specific economic realities faced by its global and Hong Kong customers, as well as the challenging operating, competitive and regulatory environment in Hong Kong's telecommunications market. The unit has implemented efficiency improvements to reduce costs and has improved marketing efforts to enhance customer service. It has grown as a result of investments in value-added services, data transmission services and broadband access-line services, which are seen as key differentiators against competitors. During the year, retail consumer Internet access and multimedia services were transferred from Internet Services into TSS for better alignment of the operating structure. Management believes the restructured TSS offers synergies and greater efficiency, which contributed to an improved operating margin.

The table below sets out the unaudited financial performance of TSS for the years ended December 31, 2001 and 2002:

Year ended December 31

	2002				2001				y-o-y
	H1 HK$ million	H2 HK$ million	Full Year HK$ million	Full Year US$ million	H1 HK$ million	H2 HK$ million	Full Year HK$ Million	Full Year US$ million	Increase/ (Decrease)
Local Telephony Services	**3,503**	**3,346**	**6,849**	**879**	3,877	3,647	7,524	965	(9)%
Local Data Services	**2,242**	**2,215**	**4,457**	**571**	2,084	2,184	4,268	547	4%
International Telecommunications Services	**1,893**	**1,664**	**3,557**	**456**	2,271	2,196	4,467	573	(20)%
Other Services	**1,467**	**1,677**	**3,144**	**403**	1,751	1,817	3,568	457	(12)%
Total Revenue	**9,105**	**8,902**	**18,007**	**2,309**	9,983	9,844	19,827	2,542	(9)%
EBITDA	**4,487**	**4,416**	**8,903**	**1,142**	4,737	4,514	9,251	1,186	(4)%
EBITDA Margin	**49%**	**50%**	**49%**	**49%**	47%	46%	47%	47%	

TSS revenue for the year ended December 31, 2002 was HK$18,007 million (2001: HK$19,827 million), 9 percent lower than a year ago. The decrease was mainly due to the significant downward pricing pressure in the international data and IDD markets; reduction in the overall number of direct exchange lines in service in Hong Kong as a result of the continuing softening of the economy, as well as a reduction in market share by PCCW resulting from continuing market competition; and the Company's conscious decision to reduce its low-margin CPE sales business. However, strong revenue growth from broadband Internet access services and an increase in revenue from wholesaling local access lines partially offset revenue declines in other areas of TSS.

Local Telephony Services Revenue from local telephony services consists of revenue from local exchange-line services, value-added services and interconnection and network access services for traffic carried for other local operators and service providers. Interconnection fees include fees for the delivery of traffic and fees for the physical interconnection of facilities, as determined by Hong Kong's Office of the Telecommunications Authority ("OFTA"), or by commercial agreements between the Company and other local carriers.

Revenue from local telephony services decreased by 9 percent year-on-year from HK$7,524 million to HK$6,849 million. This primarily reflected a decline in the number of direct exchange lines in service in Hong Kong; a lower interconnection fee revenue due to a rate reduction as determined by OFTA in October 2002, and was partially offset by an increase in revenue from wholesaling local access lines to other fixed-line operators.

The Company has maintained a leading share in Hong Kong's fixed-line telecommunications market, notwithstanding increasing liberalization since 1995, and further full liberalization since the beginning of 2003; competition from other fixed-line operators; substitution by broadband access lines and wireless telecommunications services; as well as continuing softening in the Hong Kong economy and the property market. The Company continues to launch innovative products and value-added services to help retain and win back customers and maintains the premium pricing and leading market share.

According to industry statistics provided by OFTA, the overall fixed-line telecommunications market continued to contract by approximately 2 percent in 2002. Based on the Company's estimates and OFTA's statistics, PCCW had 82 percent total market share at the end of December 2002; 84 percent in the residential sector and 79 percent in the business sector. The total number of the Company's direct exchange lines decreased by 10 percent year-on-year from approximately 3,489,000 to approximately 3,138,000; the number of business exchange lines in service decreased from approximately 1,470,000 to approximately 1,336,000 and the number of residential exchange lines decreased from approximately 2,019,000 to approximately 1,802,000.

Local Data Services Revenue from local data services consists of revenue from the provision of data and network services; wholesale broadband access lines and retail consumer Internet access services utilizing the Company's fiber-optic network and the digital subscriber line technology behind our broadband offerings.

Local data services revenue increased by approximately 4 percent year-on-year from HK$4,268 million to HK$4,457 million. This was mainly the result of a significant increase in revenue from broadband Internet access services, partially offset by a decline in revenue from the provision of local area and wide area (LAN and WAN) corporate networks, high-speed, high-volume data transmissions from mobile telephone operators and Internet service providers; and iTV, the interactive television operation terminated in the last quarter of 2002.

Demand for broadband Internet access services continued to be strong during the year. The total number of broadband access lines increased 39 percent year-on-year from approximately 402,000 to approximately 559,000. Consumer broadband numbers for NETVIGATOR, the market-leading Internet access brand, increased from approximately 311,000 to approximately 424,000.

The Group's successful marketing effort continued to focus on delivering products and services tailored to customer needs. Wireless broadband, and certain NETVIGATOR value-added services, were launched during the year to expand the customer base and maintain the brand's premium pricing and market position. Subscribers to *now.com.hk*, the broadband content service exclusive to NETVIGATOR customers, launched in September 2001, showed a remarkable year-on-year increase of 79 percent to approximately 145,000 by the end of 2002.

While other local data and network services (such as LAN and WAN corporate networks; high-speed, high-volume data transmissions from mobile telephone operators and Internet service providers) continued to face intense pricing pressure, local data bandwidth sold increased by 23 percent year-on-year to 172 Gigabits per second ("Gbps") due to an increase in demand for higher bandwidth data products such as IP-VPN.

International Telecommunications Services Revenue from international telecommunications services consists of revenue from retail outgoing IDD, retail international data services and delivery fees for the origination and termination of international calls on the Company's network.

Given retail IDD minutes dropped by 4 percent year-on-year and IPLC bandwidth also dropped significantly year-on-year, international telecommunications services revenue decreased by approximately 20 percent to HK$3,557 million for the year ended December 31, 2002 from HK$4,467 million a year ago. This is mainly a result of significant price competition in the retail IDD market, particularly on the China routes, and downward pricing pressure on international data products. Through customer-retention and win-back programs, the Company has been able to sustain its market share in the competitive IDD market in 2002. Delivery fees applicable to certain types of international traffic were lower during the year due to a rates revision determined by OFTA in July 2001.

In connection with the formation of REACH in February 2001, the venture assumed responsibility for certain wholesale international telecommunications services and the associated revenue.

Other Services Revenue from other services consists primarily of revenue from the sale of network equipment, CPE and connectivity products, fees for technical and maintenance subcontracting services, and income from Contact Centers which design, build and maintain call centers and related outsourcing services.

Revenue from other services decreased by 12 percent to HK$3,144 million for the year ended December 31, 2002 from HK$3,568 million a year ago. This was mainly due to the Company's conscious decision to reduce its low-margin computer and CPE sales business. Other factors included a weaker economy and delayed investment decisions by corporate customers. The increasing popularity of the do-it-yourself retail broadband access packages also led to a reduction in broadband installation revenue. The reduction in Other Services revenue was partially offset by revenue from Telecommunications Technology Investments Limited, the new satellite-based network communications business acquired in March 2001, and the new service hubs launched in the Greater China area.

Business eSolutions

Business eSolutions primarily includes provision of IT projects (including Internet Data Centers), retail business broadband Internet access-services and the Group's yellow pages business, PCCW Directories Limited. During the year, Internet Data Center operations were integrated into Business eSolutions. This restructuring enabled the division to offer seamless IT, hosting, facilities management and connectivity services and greatly enhanced the Group's competitive edge in this sector.

Business eSolutions revenue for the year ended December 31, 2002 was HK$2,234 million, representing a 15 percent increase from HK$1,936 million in 2001.

Revenue from IT projects (including Internet Data Centers) grew 10 percent year-on-year, from HK$1,266 million in 2001 to HK$1,397 million in 2002. Key contract work delivered during the year included provision of hardware, software and services for Hong Kong's new computer-chip ID card; and design and development of the Library Authentication System for the Leisure and Cultural Services Department. In addition, contract work included provision of a nationwide enterprise resources planning information system for a major PRC telecoms operator; and provision of IT services including facilities, operations, platform and security management. Another secured contract involved load testing, hardware and software maintenance and enhancement services for a major European bank.

Revenue from business broadband Internet access services increased 41 percent year-on-year from HK$376 million in 2001 to HK$531 million in 2002. The number of customers for the Company's high-speed business broadband and leased-line access services expanded from approximately 36,400 as at December 31, 2001 to approximately 51,800 as at December 31, 2002.

Revenue from the Group's yellow pages business remained steady at HK$306 million for the year ended December 31, 2002 compared to HK$294 million in 2001. PCCW Directories Limited remains one of Asia's market leaders in directory publications. During the year, various trades, commerce and professional directories were launched.

Infrastructure

Total revenue from Infrastructure was HK$685 million for the year ended December 31, 2002, a decrease of 50 percent from HK$1,368 million in 2001.

One-off revenue of HK$83 million for the year ended December 31, 2002, versus HK$922 million for the year ended December 31, 2001, included infrastructure works completed for the Cyberport development and revenue from the sale of certain properties in mainland China.

Despite the continued slowdown in the Hong Kong real estate market, rental revenue from investment properties leased to third parties increased during the year, principally due to higher residential occupancy in Pacific Century Place in Beijing. Overall occupancy of the portfolio improved to 90 percent at the end of 2002 from 86 percent a year earlier.

The first phase of the Cyberport development was completed on schedule, and marketing and sales for the residential portion, Residence Bel-Air, commenced in early 2003. Response has been encouraging, despite difficult market conditions.

Others and Eliminations

Other revenue primarily includes revenue from the Group's Greater China businesses, PCCW Japan, Internet Services, and CyberWorks Ventures. Other revenue increased by 70 percent to HK$793 million for the year ended December 31, 2002, from HK$468 million in 2001.

The Group continued to provide data network and mission-critical services in Taiwan through its subsidiary, Taiwan Telecommunication Network Services Co., Ltd. (TTNS), including high-speed packet data, utilizing asynchronous transfer mode (ATM), and information networks and Internet access supported by an extensive fiber-optic network.

PCCW Japan continued to focus on development and publishing of console and PC game software and targeted content across multiple distribution platforms. During 2002, 23 game titles were launched including the PCCW Japan brand title.

The Company continued to manage its ventures investment portfolio prudently during the year. The unit is self-funded, using realized gains from existing investments. Certain non-core or non-performing businesses were closed or divested during the year. Total carrying value of the Group's investment portfolio was HK$1,302 million as of December 31, 2002 against HK$2,322 million the previous year.

Eliminations of HK$1,607 million, compared to HK$1,640 million in 2001, predominantly related to internal charges for wholesale communications services consumed, computer system network charges, consumer support services and office rental charges between the Group's business units.

Costs of Sales and Services

Total costs of sales and services for the year ended December 31, 2002 were HK$5,295 million, compared to HK$6,855 million in 2001, of which approximately HK$3,993 million, against HK$4,799 million the previous year, related to TSS. The Group's overall gross margin improved from 69 percent to 74 percent, primarily driven by cost savings from restructuring the Group's Internet Services business and the significant reduction in one-off low-margin revenue from Cyberport entrustment fees and from property sales in the current year. TSS gross margin also improved from 76 percent to 78 percent, year-on-year, primarily due to a decline in wholesale international voice and data disbursements.

Operating Costs

Year ended December 31

	2002 HK$ million (Unaudited)	**2002** US$ million (Unaudited)	2001 HK$ million (Unaudited)	2001 US$ million (Unaudited)	Increase/ (Decrease)
Staff costs[1]	**3,822**	**490**	**4,522**	580	(15)%
Repair and maintenance	**443**	**57**	**503**	64	(12)%
Other operating costs	**2,432**	**312**	**2,683**	344	(9)%
Total Operating Costs before depreciation and amortization	**6,697**	**859**	**7,708**	988	(13)%

1 Staff costs include costs paid to subcontracting companies formed as part of the subcontracting program as described below.

Operating costs before depreciation and amortization decreased by 13 percent to HK$6,697 million for the year ended December 31, 2002. Operating costs for TSS also decreased by 12 percent to HK$5,111 million year-on-year. The Company continued its drive for enhanced organizational effectiveness, and implemented a number of cost-efficiency measures during the year. This resulted in substantial savings in most categories of operating expenditure.

Staff costs decreased substantially by approximately 15 percent year-on-year to HK$3,822 million. During the year, the Group reset staff levels for maximum efficiency from approximately 14,600 in 2001 to approximately 11,600 in 2002.

As part of the Company's strategic realignment plans, PCCW: (i) announced a subcontracting program in September 2002, under which about 1,600 employees in network maintenance and installation divisions took the opportunity to form 17 independent companies which then signed agreements to provide services to PCCW; and (ii) formed a new wholly-owned subsidiary, Cascade, one of Asia Pacific's leading technical services companies which will also continue to provide PCCW's telecommunications network operations, support and maintenance services. As part of the formation of Cascade, approximately 3,000 employees accepted new service contracts that generally reduced salaries slightly, as well as to realign benefit packages. Subject to contractual agreements with PCCW, the subcontracting companies and Cascade are free to pursue new business opportunities in Hong Kong and throughout Asia Pacific. Net restructuring costs of these realignments, charged to the consolidated income statement amounted to approximately HK$311 million.

Numbers of Employees

Year ended December 31

	2002	2001
TSS	**8,445**	11,296
Business eSolutions[1]	**1,280**	1,392
Infrastructure	**361**	307
Others[2]	**1,474**	1,588
Total	**11,560**	14,583
Total (excluding part-time/temps)	**10,978**	14,080

1 Business eSolutions includes Internet Data Centers.

2 Others primarily includes Corporate Functions, Greater China businesses, PCCW Japan, Internet Services and CyberWorks Ventures.

Other operating costs primarily included rent, rates and utilities, publicity and promotion and professional and consultancy fees. Publicity and promotion expenses decreased during the year after the Group's rebranding exercises were completed at the beginning of 2002. Professional and consultancy expenses also decreased in 2002.

EBITDA

Total EBITDA for the Group was HK$8,120 million for the year ended December 31, 2002, an increase of approximately 10 percent from 2001. Group EBITDA margin expanded to approximately 40 percent for the year of 2002, compared to 34 percent in 2001. The substantial improvement in EBITDA margin was primarily driven by cost savings from restructuring of the Group's Internet Services business; reduction in wholesale international traffic disbursements; overall productivity improvements in operating costs; more cautious control on corporate overheads; and the significant reduction in one-off, low-margin Cyberport entrustment fees and property sales in the current year.

TSS EBITDA for the year ended December 31, 2002 was HK$8,903 million (2001: HK$9,251 million), a 4 percent decrease against 2001. TSS EBITDA margin rose to 49 percent in 2002 from 47 percent a year ago. This is mainly attributable to a reduction in wholesale international voice and data disbursements, and productivity improvement in operating costs and reduction in sales of low-margin computer and CPE business.

Business eSolutions EBITDA increased substantially by 140 percent from HK$63 million in 2001 to HK$151 million in 2002. Business eSolutions operations continued to gain in scale during the year and EBITDA margin of the division increased from 3 percent to 7 percent, year-on-year.

Despite the significant decrease in Infrastructure revenue from HK$1,368 million to HK$685 million, year-on-year, Infrastructure EBITDA decreased only from HK$566 million in 2001 to HK$476 million in 2002 primarily due to the significant reduction in one-off, low-margin Cyberport entrustment fees and property sales in the current year.

EBITDA loss from Others, net of costs associated with corporate functions, has been further contained by 43 percent to HK$1,410 million for the year ended December 31, 2002 from HK$2,484 million a year ago. This was primarily driven by cost savings from restructuring the Group's Internet Services business; overall productivity improvements in operating costs; more cautious control on corporate overheads and the Group's other businesses, including CyberWorks Ventures and PCCW Japan.

Subsequent to the restructuring of the Group's Internet Services business at the beginning of the year, the remainder of the Internet Services division is primarily related to the production of English and Chinese Internet and broadband content. Internet Services EBITDA loss for the year ended December 31, 2002 reduced substantially to HK$78 million from HK$850 million a year ago, primarily as a result of a new business arrangement with an overseas content partner, effective from the beginning of 2002.

Highlights of Telstra Alliance

REACH

	Year ended December 31, 2002			Eleven months from Feb 1 to Dec 31, 2001		
	HK$ million[1] (HK GAAP) (Unaudited)	US$ million[1] (HK GAAP) (Unaudited)	US$ million[2] (US GAAP) (unaudited)	HK$ million[1] (HK GAAP) (Unaudited)	US$ million[1] (HK GAAP) (Unaudited)	US$ million[2] (US GAAP) (unaudited)
Revenue	**9,854**	**1,263**	**1,263**	9,978	1,279	1,279
EBITDA	**3,304**	**423**	**423**	3,104	398	398
PCCW's 50 percent share of profit before tax	**738**	**95**	**NA**	706	91	NA

1 Amounts prepared in accordance with HK GAAP.

2 Amounts prepared in accordance with US GAAP.

In February 2001, PCCW formed REACH, a 50:50 venture with Telstra, which merged the respective international infrastructure assets of both shareholders. REACH is Asia's largest international carrier of combined voice, private line and IP data services. PCCW contributed its international wholesale business to REACH at cost.

For the year ended December 31, 2002, in difficult market conditions, REACH generated total revenue of HK$9,854 million compared to HK$9,978 million for the 11 months from February 1, 2001 to December 31, 2001. PCCW's 50 percent share of profit before tax for the year ended December 31, 2002 was HK$738 million compared to HK$706 million for the 11-month period ended December 31, 2001.

A wholly-owned subsidiary of the Company and REACH have entered into a Hong Kong Domestic Connectivity Agreement, and an International Services Agreement, for the provision of domestic and international connectivity services in Hong Kong and between Hong Kong and other countries. Pursuant to the International Services Agreement, for the first five years of operations subsequent to the formation of REACH in February 2001, the Group is required to acquire 90 percent, 90 percent, 80 percent, 70 percent and 60 percent per annum, respectively, of its total annual purchases of "Committed Services" (being international public switched telephone network terminating access, international transmission capacity and Internet gateway access services) from REACH. The Hong Kong Domestic Connectivity Agreement contemplates a reciprocal arrangement, whereby the Group will provide local connectivity services to REACH under similar terms and conditions. Both agreements are subject to renegotiation when the agreements expire in 2006.

In addition, the Group entered into one year fixed price bulk purchase arrangements for international connectivity services from January 1, 2002, which committed the Group to aggregate purchase levels in 2002. The Group's commitments under these arrangements had regard to its future capacity needs and opportunities for growth as well as REACH's minimum earnings requirements under its financing arrangements. Regulated services in Hong Kong were acquired in accordance with tariffs approved by the relevant regulatory authority and unregulated services were acquired in accordance with market prices. Purchases made by the Group for the year ended December 31, 2002 were approximately HK$1,443 million, compared to approximately HK$1,700 million the previous year.

PCCW has, historically, been a substantial acquirer of cross-border connectivity services supplied by REACH, and expects to continue to require these services to support the Group's domestic business.

In view of the continuing difficult and volatile trading conditions in which REACH operates, the directors announced on February 20, 2003 that the Company has performed a preliminary review of REACH in accordance with the requirements of SSAP 31 – "Impairment of assets", to ascertain whether there has been an impairment in the total investment cost in REACH.

An analysis of the Company's total investment cost in REACH as at December 31, 2002 is as follows:

HK$ million	Book carrying value	Goodwill (Note)	Total investment cost
Balances as at December 31, 2002, as previously announced on February 20, 2003	3,964	8,263	12,227
Adjustment to goodwill arising from adoption of new accounting standard for deferred taxation	(349)	315	(34)
Balances, as restated	3,615	8,578	12,193
Impairment loss for the goodwill attributable to the interest in REACH	–	(8,263)	(8,263)
Balances as at December 31, 2002	3,615	315	3,930

Note:
Interpretation 13 issued by the Hong Kong Society of Accountants in 2001 requires that the balance of goodwill previously charged against the reserve account of the balance sheet of the Company as a result of the Company's acquisition of PCCW-HKT Limited ("HKT") and its subsidiaries, and not previously realized or charged to the income statement through provision for impairment, be subject to impairment review.

Based on the results of this review, the Directors believe that an impairment loss of HK$8,263 million should be recognized for the goodwill attributable to the Company's investment in REACH and such amount is included in the consolidated loss attributable to shareholders of the Company for the year ended December 31, 2002.

The impairment loss on the Company's investment in REACH has no impact on revenue, profit from operations, EBITDA or cash flow of the Group and will not result in any non-compliance with respect to the Group's debt covenants. In addition, the recognition of an impairment loss on goodwill does not result in an increase in the shareholders' deficit of the Group as at December 31, 2002.

The Directors' decision, in relation to the provision, was made after consideration of the difficult and volatile trading conditions in the undersea and long-haul telecommunications sectors. The Directors will continue to review both REACH's business development and financial performance.

REACH is currently in negotiations with its bankers to restructure the terms of a syndicated bank loan of US$1,500 million. REACH continues to operate in difficult and volatile conditions and its ability to continue as a going concern is dependent on successful renegotiation of its existing bank loan, or other forms of funding being made available. Discussions with the banks continue to be constructive.

RWC

RWC, previously 40 percent owned by the Group, generated revenue of HK$2,120 million and EBITDA of HK$698 million for the six months ended June 30, 2002. On June 28, 2002, the Group sold its 40 percent interest in RWC to Telstra for a total net consideration of HK$4,792 million.

On June 28, 2002, PCCW and Telstra entered into, and completed, an agreement relating to the following:

- The sale by the Company of its entire 40 percent equity interest in RWC to Telstra for a consideration of approximately US$614 million (approximately HK$4,792 million);

- The redemption by the Company of the outstanding principal amount of the US$750 million (approximately HK$5,850 million) variable coupon subordinated convertible bond due 2007 ("2007 Bond") together with accrued interest of approximately US$54.38 million (approximately HK$424 million); and

- The issue by the Company of a US$190 million (approximately HK$1,482 million) 5 percent mandatory convertible note due 2005 ("2005 Note") to Telstra.

The proceeds from the sale of the interest in RWC and the issue of the 2005 Note were offset in full against the amount due to Telstra by PCCW for the redemption of the 2007 Bond with interest accrued thereon. Accordingly, no net proceeds arose from the sale of the interest in RWC.

The effect of the above transactions is to reduce the Group's debt position. The sale of the interest in RWC also aligns with the Group's intention of focusing on core fixed-line, data and Internet protocol businesses as well as systems integration.

The realization of the Group's investment in RWC significantly reduced the shareholders' deficit position but gave rise to a HK$1,771 million disposal loss, adjusted by deferred tax, in the year. The disposal loss had no impact on cash flows and was due to the inclusion of goodwill previously eliminated against reserves as cost of disposal in the current year's audited consolidated income statement.

Financial Highlights of Audited Consolidated Results

Depreciation and amortization

Depreciation and amortization for the year ended December 31, 2002 was HK$2,832 million compared to HK$2,563 million for the year ended December 31, 2001.

Operating Profit before Net Gains on Investments, Provision for Impairment Losses and Restructuring Costs

Operating profit before net gains on investments, provision for impairment losses and restructuring costs increased by approximately 9 percent to HK$5,212 million for the year ended December 31, 2002 from HK$4,774 million for the year ended December 31, 2001 primarily due to the aforementioned reasons for the increase in EBITDA.

Net Gains on Investments

HK$ million	**2002**	2001
Net unrealized losses on investments	**(142)**	(194)
Net realized (losses)/gains from disposal of investments in subsidiaries, investment securities and other investments	**(92)**	261
Provision for impairment of investments	**(581)**	(263)
Amortization of premium received from equity options	**32**	361
Release of provision for an onerous contract	**464**	477
Gain on termination of interest rate swap contracts	**332**	–
Dividend income[1]	–	125
	13	767

1 Balance represents 60 percent of profit of the Group's wireless communications business before February 2001 when the venture with Telstra was formed.

Provision for Impairment Losses

Provision for impairment losses of HK$534 million for the year ended December 31, 2002, against HK$91 million the previous year, increased mainly due to the higher provision made for certain fixed assets, intangible assets and associates, including the provisions for the remaining portion of the goodwill relating to the Internet Services business and for *Power***b@se**, the Group's Internet Data Centers infrastructure in Hong Kong.

Restructuring Costs

During the current year, the Group subcontracted a significant portion of its network maintenance function to 17 newly-established companies owned by staff previously employed by the Group. Approximately 1,600 former employees joined these subcontracting companies in November 2002, and approximately 3,000 of the Group's employees joined a new wholly-owned subsidiary, Cascade, on January 1, 2003. In addition, the Group reset staff levels for maximum efficiency from 14,583 in 2001 to 11,560 in 2002. Restructuring costs mainly represent the ex-gratia payments, curtailment loss on retirement scheme, Cascade incentive bonus and payment in lieu of notice for the above exercises.

Net Finance Costs

Net finance costs decreased by approximately 35 percent to HK$1,997 million for the year ended December 31, 2002 from HK$3,056 million for the year ended December 31, 2001, primarily due to the 16 percent decrease in Net Debt, substantial decline in interest rates, and decrease in amortization of arrangement fees. Average cost of debt, calculated as total interest, including finance fees, over average debt outstanding, decreased from 6.6 percent to 5 percent year-on-year. The general interest rate reduction also led to a decrease in interest income on bank deposits.

Share of Results of Jointly Controlled Companies

Share of results of jointly controlled companies for the year of HK$550 million compared to HK$523 million in 2001, comprise the Group's 50 percent share of profit from REACH, the 50:50 venture with Telstra, of HK$738 million (HK$706 million for the 11-month period from February 1, 2001 to December 31, 2001), net of the Group's share of losses of other jointly controlled companies for the year.

Share of Results of Associates

Share of results of associates for the year of HK$281 million, compared to HK$158 million in 2001, comprised the Group's 40 percent share of profit from RWC of HK$137 million from January 1, 2002 to the date of disposal of June 28, 2002 (HK$289 million for the 11-month period from February 1, 2001 to December 31, 2001) and the Group's share of profit of HK$301 million, against HK$62 million in 2001, from Great Eastern Telecommunications Limited, the company jointly owned by PCCW and Cable and Wireless plc, which holds shares in MobileOne; net of the Group's share of losses of other associates for the year.

Share of Results of Unconsolidated Subsidiaries

The Group has no unconsolidated subsidiaries for the current year. Share of results of unconsolidated subsidiaries for the year ended December 31, 2001 of HK$152 million included the Group's 40 percent share of profit from RWC's wireless communications business of HK$24 million and the Group's 100 percent share of profit from the Group's Internet Protocol Backbone business for the month of January 2001 of HK$128 million, prior to the formation of the ventures with Telstra.

Taxation

Taxation for the year ended December 31, 2002 was HK$1,406 million compared to HK$1,982 million in 2001. The 29 percent decrease was primarily due to a retrospective restatement of the prior year's taxation balance to take into account the change in the accounting standard on income taxes as a result of the adoption of SSAP 12, "Income Taxes", issued by the Hong Kong Society of Accountants with effect from January 1, 2002.

The Group's effective tax rate was 44 percent for the year ended December 31, 2002, excluding the impairment loss for goodwill attributable to the interest in REACH and net losses on disposal of the interests in RWC and MobileOne. Under the current tax system in Hong Kong, the Group does not enjoy any group relief on losses. Furthermore, the Group's financing costs, to the extent that they are attributable to the acquisition of HKT and other companies, are not tax deductible. Excluding these factors, the profitable companies in the Group have an effective tax rate which is approximately the statutory tax rate of 16 percent. Management does not believe there is tax inefficiency in those companies but will continue to review and minimize the Group's tax costs, subject to the constraints of existing Hong Kong tax rules.

Loss for the Year Attributable to Shareholders

The shift to a substantial loss attributable to shareholders of HK$7,762 million for the year ended December 31, 2002 from the restated net profit of HK$1,343 million for the year ended December 31, 2001 is largely attributable to an impairment loss recognized for the goodwill in relation to the Group's investment in REACH, amounting to approximately HK$8,263 million. In addition, upon disposal of the Group's 40 percent interest in RWC, an accounting loss of approximately HK$1,771 million was also created. These accounting losses are mainly a result of the inclusion of goodwill previously eliminated against reserves in the current year's impairment provision and in the cost of disposal. The accounting treatment has no impact on the Group's operations, cash flows, revenue, profit from operations or EBITDA.

Net profit for the year ended December 31, 2002, before non-recurring items, comprising impairment loss for goodwill attributable to the Group's interest in REACH; accounting loss on disposal of the Group's 40 percent interest in RWC; profit on disposal of partial interest in MobileOne; and restructuring costs; was HK$2,245 million, an increase of 67 percent compared to the restated net profit of HK$1,343 million in 2001. Profit attributable to shareholders for the year ended December 31, 2001 was restated as a result of the retrospective restatement of the prior year's taxation balance on adoption of SSAP 12, issued by the Hong Kong Society of Accountants with effect from January 1, 2002.

Liquidity and Capital Resources

The Group continued to maintain a solid financial position to underpin its operations. As at December 31, 2002, the Group had Net Cash (cash and cash equivalents plus fixed deposits for banking facilities for the Cyberport project minus short-term borrowings) of HK$8,447 million, compared to HK$8,570 million in 2001, gross long-term debt of HK$41,366 million, against HK$47,875 million the previous year, and Net Debt of HK$32,919 million, compared to HK$39,305 million in 2001.

Cash Flow

The Group generated strong operating cash flows for the year ended December 31, 2002:

Year ended December 31

	2002 HK$ million	2002 US$ million	2001 HK$ million	2001 US$ million
Operating cash flow after interest and taxes[1]	**4,962**	**637**	4,593	589
Less: Capital expenditure	**(1,611)**	**(207)**	(2,415)	(310)
Operating cash flow after interest, taxes and capital expenditure	**3,351**	**430**	2,178	279
Less: Investment in Cyberport	**(2,204)**	**(283)**	(1,260)	(162)
Operating cash flow after interest, taxes, capital expenditure and investment in Cyberport	**1,147**	**147**	918	117

1 Operating cash flow after interest and taxes is net cash inflow from operating activities before investment in Cyberport and changes in fixed deposits.

Operating cash flow, after interest, taxes and capital expenditure (but before investment in Cyberport development), increased significantly by 54 percent to HK$3,351 million from HK$2,178 million, year-on-year, as a result of the robust recurring cash flow generated by the core telecommunications business, lower net interest payments and cautious control over capital expenditure. Operating cash flow after interest, taxes, capital expenditure and investment in Cyberport development for the year ended December 31, 2002, was HK$1,147 million, a 25 percent increase on the previous year.

Debt Refinancing

Management has continued to de-leverage the Group by reducing gross long-term debt by approximately 14 percent from HK$47,875 million as at December 31, 2001 to HK$41,366 million as at December 31, 2002. Net Debt decreased by 16 percent from HK$39,305 million to HK$32,919 million, year-on year.

In January 2002, the Group issued US$450 million 1 percent convertible bonds due 2007, which are unconditionally and irrevocably guaranteed on a joint and several basis by the Company and PCCW-HKT Telephone Limited ("HKTC"), an indirect wholly-owned subsidiary of the Company. The net proceeds were used to prepay a portion of the US$4,700 million term loan facility of HKTC established in February 2001 ("Term Loan Facility") and for working capital purposes.

Subsequently in March and April 2002, HKTC raised two term loan facilities of HK$5,000 million each, due for repayment in 2008 and 2009, respectively. The proceeds of these two loans were used to further prepay a portion of the outstanding Term Loan Facility.

In addition to the refinancing as described above, HKTC prepaid a total of approximately HK$2,943 million (approximately US$377 million) of the outstanding portion of the Term Loan Facility during the year using internal cash resources. At the end of 2002, the outstanding balance of the Term Loan Facility was approximately HK$6,094 million (approximately US$781 million) due in February 2008.

As part of the Group's sale of its entire 40 percent equity interest in RWC to Telstra in June 2002, the proceeds from the disposal and the issue of a US$190 million 2005 Note to Telstra were offset in full against the amount due by the Company to Telstra for the redemption of the 2007 Bond plus interest accrued thereon. The net effect on total debt was a reduction of US$614 million.

The Directors consider that it is not meaningful to publish a gearing ratio for the Group until such time as the Group is in a positive shareholders' equity position.

New Financings in 2003

In January 2003, a member of the Group privately placed US$456 million Guaranteed Notes due 2013 to raise funds for general corporate purposes. The notes are unconditionally and irrevocably guaranteed by the Company.

On March 14, 2003, PCCW completed a 5-year term loan facility for HK$3,003 million (approximately US$385 million) on an unsecured basis. The loan is repayable in 2008. The proceeds will be used for general corporate purposes.

Based on the Group's working capital projection, which has taken into account the available banking and other borrowing facilities of the Group, for the year ended December 31, 2002, the Company is of the opinion that the Group has adequate working capital to meet its current requirements.

Credit Ratings of HKTC

On September 5, 2002, Standard & Poor's Ratings Services ("S&P") affirmed its BBB corporate credit rating on HKTC and revised upward its outlook on HKTC to positive from stable. HKTC maintained an investment-grade credit rating from Moody's Investors Service ("Moody's") of Baa1 (stable outlook).

On February 7, 2003, Moody's stated that it would review the Group's strategy as well as the underlying performance of its core business and placed HKTC's ratings on review for possible downgrade. On February 21, 2003, S&P expressed an intention to review the outlook on the rating of HKTC. Management of the Group looks forward to the opportunity of reaffirming with the rating agencies the improving credit fundamentals at HKTC.

Capital Expenditure

Capital expenditure for the year ended December 31, 2002 amounted to HK$1,611 million (approximately US$207 million), compared to HK$2,415 million (approximately US$310 million) in 2001 which consisted, principally, of investments in the local network to meet increased broadband demand, expansion of the core broadband network, IP-VPN technology, and technology for the delivery of new Internet Services to businesses and consumers.

PCCW has made significant investment in its communications network in previous years. This has included upgrade and expansion of network coverage, and building a platform for broadband and IP initiatives. Besides on-going core network expansion, the bulk of 2003 capital expenditure will be on meeting demand for new broadband access lines, value-added services, and on continuously investing in other new services and initiatives. PCCW will continue to invest prudently, using strict criteria, including internal rate of return, net present value and payback period, depending on the type of business.

Investment in Cyberport Development

The Group invested approximately HK$2,204 million, compared to HK$1,260 million in 2001, in the Cyberport project for the year ended December 31, 2002, bringing the cumulative total investment in the project to approximately HK$3,890 million by the end of 2002. The Group will continue to contribute equity into the Cyberport development in the near term before the project becomes self-funding. The sales of Residence Bel-Air, the residential portion of the Cyberport development, started in February 2003.

Dividend

The Directors do not recommend the payment of a final dividend for the year ended December 31, 2002 (2001: Nil).

Charge on Assets

As at December 31, 2002, certain assets of the Group with an aggregate value of HK$4,357 million, against HK$2,776 million the previous year, were pledged to secure loan facilities utilized by the Group.

Certain other investments, with an aggregate value of HK$237 million, were placed as collateral in relation to certain equity-linked transactions executed during the year.

In addition, the Group was granted a standby letter of credit facility that was secured by a charge over bank deposits of approximately HK$720 million, compared to HK$1,405 million in 2001.

The Group's interest in REACH was also used to secure the 2005 Note.

Contingent Liabilities

HK$ million	2002	2001
Performance guarantee	**74**	48
Others	**60**	111
	134	159

On April 23, 2002, a writ of summons was issued against HKT, a wholly-owned subsidiary of the Company, by New Century Infocomm Tech Co., Ltd. for its failure to purchase 6,522,000 shares of TTNS, a subsidiary of the Company, pursuant to an option agreement entered into on July 24, 2000. The total claim against HKT amounted to approximately HK$90 million (NT$418 million), being the purchase price of shares in TTNS, contractual interest for the period January 1, 2001 to January 2, 2002 at 6.725% per annum, and interest on the due amount pursuant to Sections 48 and 49 of the High Court Ordinance, Cap 4. However, this figure should be reduced by the current market value of shares in TTNS, which would be transferred to HKT in the event that the claimants were successful. A defence was filed by HKT on May 29, 2002. Based on legal advice received, the Directors consider that HKT has valid defences, therefore no provision has been made.

Employees

As of December 31, 2002, the Group had approximately 11,600 employees compared to 14,600 in 2001. The majority of these employees work in Hong Kong. The Company has established incentive bonus schemes designed to motivate and reward employees at all levels to achieve the Company's business performance targets. Payment of bonuses is based on achievement of revenue and EBITDA targets for the Company's individual businesses and the Group as a whole. The Company also operates a discretionary employee share option scheme to motivate employee performance in enhancing shareholder value. In 2002, the Company also established two share award schemes under which awards of the Company's shares are made to recognize contributions of certain of the Group's employees in order to retain them for the continued operation and development of the Group, and to attract suitable personnel for the further development of the Group.

Hedging

Market risk arises from foreign currency exposure and interest rate exposure related to cash investments and borrowings. As a matter of policy, the Group continues to manage market risk directly relating to its operations and financing, and does not undertake any speculative derivative trading activities. The Finance Committee, a subcommittee of the Executive Committee of the board of directors, determines appropriate hedging activities undertaken with the aim of managing, prudently, market risk associated with transactions undertaken in the normal course of the Group's business. All treasury risk management activities are carried out in accordance with policies and guidelines approved by the Finance Committee and the Executive Committee, which are reviewed on a regular basis.

In the normal course of business, the Group enters into forward contracts and other derivative contracts in order to limit its exposure to adverse fluctuations in foreign currency exchange rates and interest rates. These instruments are executed with creditworthy financial institutions, and all contracts are denominated in currencies of major industrial countries. Gains and losses on these contracts serve as hedges in that they offset fluctuations that would otherwise impact the Group's financial results. Costs associated with entering into such contracts are not material to the Group's financial results.

Outlook

As the results for the past year demonstrate, the Group has been able to deliver strong operating results from its core businesses through difficult market conditions. However, the businesses are not immune to the realities of the global slowdown, or significant competition. The Group's 2002 results also show that management has taken difficult decisions to continue to adjust to these new realities, particularly given the substantial realignment undertaken at TSS and the substantial goodwill impairment recognized in relation to REACH.

Looking ahead to the rest of 2003, the Group continues to face many of the same challenges. In light of geopolitical and economic uncertainties, the Company's Hong Kong and international customers continue to be cautious and cost conscious. Competition continues to be relatively strong in core markets, which puts pressure on both market share and pricing.

Nonetheless, the Group believes that many of the innovative and aggressive actions it continues to pursue will position it well to deliver sound operating results over the medium-term. Despite difficult market conditions, the Group expects that its business and revenue mix will continue to change over time as the eSolutions and value-added services businesses continue to grow. The Company is launching innovative products and services, and pricing packages, to help retain and win back customers, and to attempt to maintain stable revenues despite continuing downward pressure on pricing. The realignment and cost-adjustment measures undertaken in 2002 should further reduce costs in 2003, although the Group's costs could also be negatively impacted by the Group's changing business mix.

The Group's free cash flow generation should continue to improve. This is particularly true as the net cash investment to the Cyberport development should decline significantly in 2003, relative to 2002, as the proceeds of residential sales at Residence Bel-Air begin to cover some of the ongoing construction costs.

The Group expects to use a substantial portion of this cash flow to continue to reduce its outstanding debt. Last year, the Group stated its intention to pay down a further US$1 billion in the years 2002 through to 2005, and has already paid US$377 million of that target. This, and other operating and strategic initiatives, should continue to move the Group towards its stated target of achieving single "A" ratings at HKTC from both S&P and Moody's.

While the debt reduction targets and ratings goals remain the Group's priorities, the Group's management team remains focused on forming strategies to deliver sustained value and growth to shareholders over the coming years. However, in light of global political and economic uncertainties, the Group has adjusted its focus to further strengthen its balance sheet in the interests of all investors. Therefore, the Company has decided it will not pay a dividend in 2004.

The Company's target is to pay a dividend in the medium-term. However, the Group first wants to make significant progress towards its previously announced goals of: 1) continuing to reduce debt by US$1 billion from 2002 to the end of 2005 (of which US$377 million has already been paid), and 2) achieving the desired "A" ratings.

Furthermore, the Company will continue to look for ways to improve revenue by considering new investments that are consistent with financial priorities and that meet the Group's strict investment criteria.