MANAGEMENT DISCUSSION AND ANALYSIS

Overview

SmarTone's strong recovery in financial performance in 2001/02 continued for 2002/03. The Group achieved a profit attributable to shareholders of HK$408 million for 2002/03 (2001/02: HK$115 million).

The better financial performance in 2002/03 arose as follows:

- The mobile business achieved earnings before interest and tax ("EBIT") in 2002/03 of HK$333 million (2001/02: HK$105 million). The financial performance of both the Hong Kong and Macau mobile businesses substantially improved during the year.
- The Internet services provider ("ISP") business was closed during 2002/03. During 2002/03, the business achieved EBIT break-even (2001/02: EBIT loss of HK$82 million).
- There was no charge for impairment of fixed and other assets during 2002/03 (2001/02: HK$122 million).

Profit attributable to shareholders for the second half of 2002/03 of HK$170 million was lower than the first half of HK$238 million, mainly due to the SARS epidemic and increased market competition.

Mobile

The mobile business achieved earnings before interest, tax, depreciation and amortisation ("EBITDA") for 2002/03 of HK$751 million (2001/02: HK$573 million). Turnover was higher while cost of services provided and other operating expenses were both lower. EBITDA for the second half of 2002/03 was HK$359 million compared to HK$392 million in the first half. This was mainly due to a drop in roaming revenue in April to June 2003 due to the SARS epidemic and increased market competition.

Turnover increased by HK$470 million to HK$2,819 million in 2002/03 (2001/02: HK$2,349 million). Mobile service revenue was higher by HK$92 million and handset and accessory sales by HK$378 million.

- Mobile service revenue increased mainly due to higher prepaid revenue arising from higher average Hong Kong prepaid ARPU during 2002/03. Postpaid revenue was flat in 2002/03. However, data revenue increased significantly, albeit from a low base, as more data services with compelling customer propositions were introduced. Average Hong Kong postpaid ARPU for 2002/03 was HK$213 per month (2001/02: HK$210 per month). However, this was offset by lower average postpaid customers. Hong Kong mobile average blended ARPU (calculated as mobile services revenue divided by the total number of postpaid and prepaid customers) for 2002/03 increased by 7 per cent. to HK$183 (2001/02: HK$171).
- Handset and accessory sales increased primarily due to the introduction of new models during 2002/03 with advanced features such as colour screens and embedded cameras.

Total customers of the Hong Kong mobile business was 966,000 as at 30 June 2003. The 2002/03 year end monthly postpaid churn rate was 2.6% compared to 3.0% at the end of 2001/02. This improvement was because the Group has been offering the best customer proposition in the market with its continual enhancements in service quality and competitive pricing.

Cost of goods sold and services provided in 2002/03 increased to HK$871 million (2001/02: HK$567 million). This resulted from higher cost of handsets due to the increased number sold. Other cost of goods sold and services provided decreased due to lower interconnect charges.

Other operating expenses (excluding depreciation) decreased in 2002/03 to HK$1,197 million (2001/02: HK$1,209 million). Most categories of expense were lower due to improvements in the efficiency of the organisation and its systems and processes. The reduction in operating expenses was achieved notwithstanding the Group continuing to improve productivity and competitiveness, while enhancing service quality, improving its branding and accelerating the rate of bringing new services to market. However, network costs increased due to the efforts in improving its already market-leading network quality.

The Group's mobile business in Macau made a small EBIT profit in the first half of 2002/03 but an EBIT loss in the second half due to the effect of SARS. Overall, Macau made a small EBIT loss in 2002/03.

ISP business

The Group's ISP business achieved approximately EBIT break-even during 2002/03 and was closed in June 2003. The obligations of the outstanding performance bonds of HK$56 million were satisfied during the year and the bonds released.

Subsidiaries, associates and other investments

There have been no significant subsidiary companies acquired or established during the year.

The Group has invested in three telecom and technology venture capital funds, one of which is held via an investment in an associated company. During the year ended 30 June 2003, an additional provision was made of HK$17 million against one of these funds to reflect its current estimated market valuation. The Directors are of the opinion these investments are conservatively valued.

There were no disposals of subsidiaries, associates or other investments during the year ended 30 June 2003.

Capital structure, liquidity and financial resources

The Group is financed entirely by share capital and internally generated funds and has no external borrowings. The cash reserves of the Group remain strong with cash and bank balances and fixed income investments of HK$3,923 million at 30 June 2003, an increase of HK$337 million during 2002/03.

The Group invests a proportion of its surplus cash in held-to-maturity investment grade fixed income investments to generate a better rate of return. During the year, the Group invested an additional HK$685 million (2001/02: HK$682 million) in such investments. The Group received proceeds during the year of HK$173 million (2001/02: Nil) from sales of held-to-maturity investment grade fixed income investments and proceeds of HK$429 million (2001/02: HK$39 million) from the early redemption of investments by their issuers.

The Group had a net inflow from operating activities during the year of HK$844 million. Interest income during the year was HK$72 million (2001/02: HK$86 million). Higher average cash balances were offset by lower average interest rates obtainable in the marketplace. Interest income for the year is net of a loss of HK$6 million arising from the disposal of held-to-maturity investment grade fixed income investments during the year. In addition to the purchase of fixed income investments, the Group's other major outflows of funds during the year were purchase of fixed assets and payment of dividends.

The Directors of the Group are of the opinion that the Group can fund its capital expenditure for the current financial year ending 30 June 2004 from existing cash resources.

Treasury policy

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

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

The Group is required to arrange for banks to issue performance bonds and letters of credit on its behalf. In certain circumstances, the Group will partially or fully collaterise such instruments by cash deposits to lower their issuance cost. Total amount of pledged deposits at 30 June 2003 was HK$392 million (30 June 2002: HK$525 million).

Functional currency and foreign exchange exposure

The functional currency of the Group is the Hong Kong dollar. All material revenues, expenses, assets and liabilities, except its United States dollar fixed income investments and bank deposits, are denominated in Hong Kong dollars. The Group does not therefore have any significant exposure to foreign currency gains and losses other than those arising due to its United States dollar denominated bank deposits and fixed income investments. The Group does not currently undertake any foreign exchange hedging.

Contingent liabilities

Performance bonds

Certain banks, on the Group's behalf, have issued performance bonds to the telecommunications authorities of Hong Kong and Macau in respect of obligations under licences issued by those authorities. The total amount outstanding at 30 June 2003 under these performance bonds was HK$202 million (30 June 2002: HK$308 million). All performance bonds were fully cash collateralised using surplus cash deposits. The decrease during the year arose as follows:

- The remaining performance bond obligations totalling HK$56 million relating to the Group's LMDS licence were released as discussed under ISP business above.

- The performance bond in respect of the Group's licence for 3G services was reduced by HK$50 million to HK$200 million in accordance with a one-year waiver granted by the Telecommunications Authority of Hong Kong.

Lease out, lease back arrangement

A bank, on the Group's behalf, has issued a letter of credit to guarantee the Group's obligations under a lease out, lease back arrangement entered into during the year ended 30 June 1999. This letter of credit is fully cash collateralised using surplus cash deposits. The Directors are of the opinion that the risk of the Group being required to make payment under this guarantee is remote.

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

Employees and share option scheme

The Group employed approximately 1,280 full-time employees as at 30 June 2003, with the majority in Hong Kong. Staff receive a remuneration package consisting of basic salary, bonus and other benefits. Bonus payments are discretionary and depend, inter-alia, on both the Group's performance and the performance of the individual employee. Benefits include a mandatory provident fund scheme and medical and dental care insurance. Staff members are provided with both internal and external training appropriate to each individual's requirements.

During the year, the Company resolved to terminate its existing employee share option scheme and adopt a new scheme. At 30 June 2003, options to subscribe for 5,200,000 shares were outstanding under the new scheme and there were no options outstanding under the old scheme. The options outstanding under the old scheme either lapsed, or were acquired for a nominal amount pursuant to the mandatory general offer by Cellular 8 Holdings Limited for the Company's shares completed in January 2003.

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