Financial review

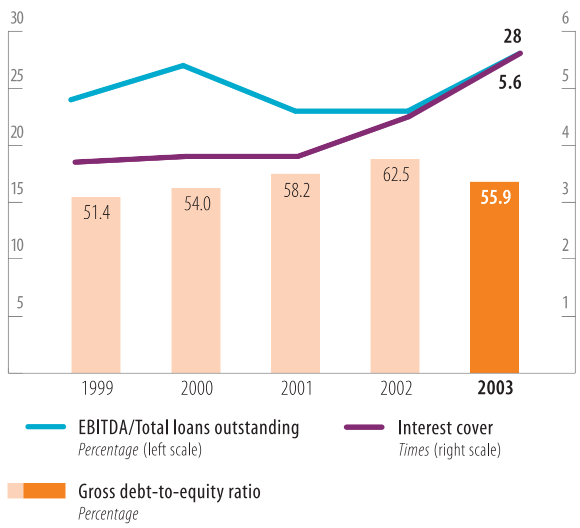
Review of 2003 financial results

Profit and loss

Railway patronage was adversely affected by the outbreak of SARS in the first half of 2003 but the strong economic recovery in the second half helped to minimise the impact. As a result, total patronage for the MTR Lines, comprising the Urban Lines, the Tung Chung Line and the Tseung Kwan O Line, decreased moderately by 0.9%, from 777 million in 2002 to 770 million in 2003. Average weekday patronage for the year decreased to 2.24 million from 2.26 million in 2002. Our overall market share of Hong Kong public transport increased to 24.3% from 23.5% in 2002, and our cross-harbour market share increased from 58.2% in 2002 to 58.7%.

Debt servicing capability

MTR maintained a very strong level of debt servicing coverage.



Total fare revenue for the MTR Lines amounted to HK$5,064 million, which was 2.0% below the figure of HK$5,167 million in 2002. The average fare decreased slightly from HK$6.65 in 2002 to HK$6.57 due to the increase in free rides provided through fare promotion schemes such as the "Ride 10 Get One Free" campaign, which was well received in 2003 and has been relaunched in 2004. In light of the sluggish economic environment in Hong Kong, the Board of Directors decided not to increase our fares.

The average daily patronage on the Airport Express Line declined by 19.4% to 18,700 from 23,200 in 2002, as SARS led to a fall in visitor arrivals and departures at the airport. Our estimated market share of passengers travelling to and from the airport fell from 25% in 2002 to 23%. Total revenue from the Airport Express Line dropped by 23.1% to HK$425 million, with the average fare decreasing from HK$65.43 to HK$62.07 in 2003 as a result of the promotional campaign and fare concessions on the Airport Express Line.

Non-fare revenues increased by 7.1% from HK$1,966 million in 2002 to HK$2,105 million, comprising HK$1,117 million from station commercial and other revenue and HK$988 million from property rental and management. Station commercial and other revenue increased by 14.1% compared to 2002, attributable to increases in rental income from new station kiosks and growth in external consultancy revenues. Property rental and management income increased marginally by 0.1% compared with 2002 despite the effect of SARS, partly due to increases in income from the expanded management and investment property portfolio, including Two IFC.

Operating costs were generally contained and productivity gains continued. Despite a full year's operation of the new Tseung Kwan O Line, operating expenses before depreciation increased by a moderate 4.8% from HK$3,672 million in 2002 to HK$3,847 million. Staff costs increased from HK$1,579 million in 2002 to HK$1,643 million, reflecting additional costs in respect of the Tseung Kwan O Line and ex-gratia payments made under the voluntary separation scheme. Other routine railway operating costs generally increased in line with the full year's operation of the Tseung Kwan O Line and additional costs incurred in relation to SARS. Expenditure relating to station commercial and other income increased significantly due to growth in external consultancy and other business activities. Other expenses increased to HK$187 million from HK$105 million in 2002 as a result of inclusion of a non-recurring HK$69 million deficit on property revaluation relating to our head office building at Telford Plaza.

Operating profit from railway and related operations before depreciation amounted to HK$3,747 million, a decrease of 6.7% from HK$4,014 million in 2002. This represents a margin of 49.3% compared with 52.2% in 2002. Excluding the non-recurring charges, the operating margin would have been 50.3%.

Profit on property developments increased significantly to HK$5,369 million as compared with HK$3,755 million for the previous year, largely due to the share of profit in kind in respect of Two IFC and Sorrento development at Union Square, as well as the profit recognition of deferred income in respect of Kowloon Package 4, The Harbourside and Tung Chung Package 3, Caribbean Coast developments in line with their construction progress and the pre-sale of properties.

In light of the growth in property profits in 2003, operating profit before depreciation increased by 17.3% to HK$9,116 million. During the year, the Company conducted a periodic review of the estimated useful lives of its fixed assets, leading to net reduction in annual depreciation charge. The annual depreciation expense therefore reduced to HK$2,402 million from HK$2,470 million in 2002.

Net interest expense increased from HK$1,125 million in 2002 to HK$1,539 million, accounted for by the first full year's interest charge in respect of the Tseung Kwan O Line following its commissioning in August 2002. However, the average interest rate paid by the Company reduced from 5.4% in 2002 to 5.1% in 2003 whilst the interest cover increased to 5.6 times from 4.5 times in 2002 in line with the increase in operating profit.

Following the adoption of the revised accounting standard on income taxes from 1 January 2003, the Company recognised an amount of HK$748 million mostly in respect of its deferred income tax expense for the year, of which HK$300 million related to the increase in Profits Tax rate from 16% to 17.5%. It should be noted that this deferred income tax expense is a non-cash item.

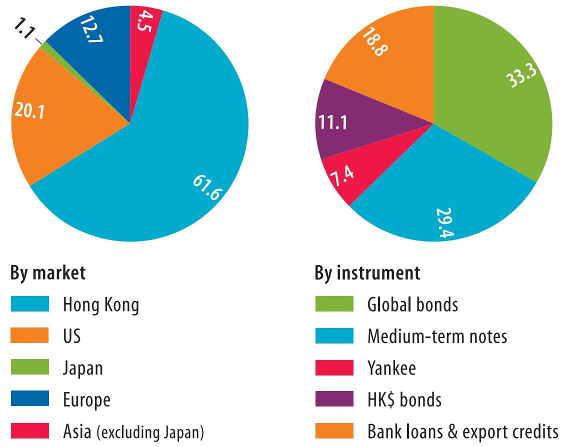
Together with the Company's share of Octopus Cards Limited's earnings of HK$23 million, the Group's profit attributable to shareholders for the year was HK$4,450 million, an increase of 24.3% compared to HK$3,579 million (as restated for deferred income tax) in 2002, with earnings per share of HK$0.85.

The Board has recommended a final dividend of 28 cents per share, amounting in total to HK$1,481 million for 2003, with a scrip dividend option offered to all shareholders with Hong Kong addresses. As in previous years, the Government has agreed to receive its entitlement to dividends in the form of shares to the extent necessary to ensure that a maximum of 50% of MTR's total dividend will be paid in cash.

Sources of borrowing

MTR took advantage of favourable conditions in the Hong Kong dollar market to further reduce its borrowing costs.

Percentage (As at 31 December 2003)

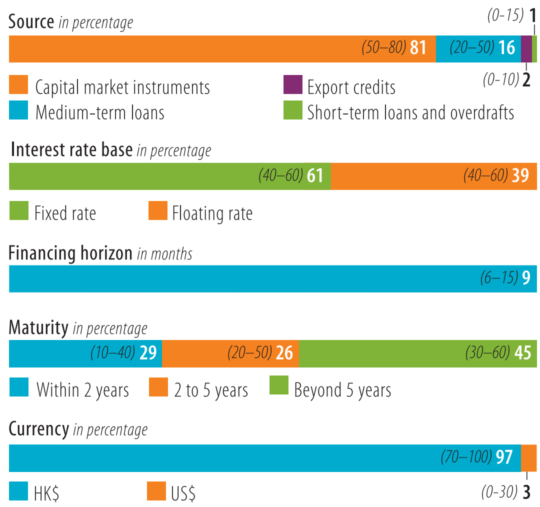


Preferred financing model and debt profile

Continued adherence to the Preferred Financing Model helped ensure a well-balanced debt portfolio.

(Preferred Financing Model) vs. **Actual debt profile**

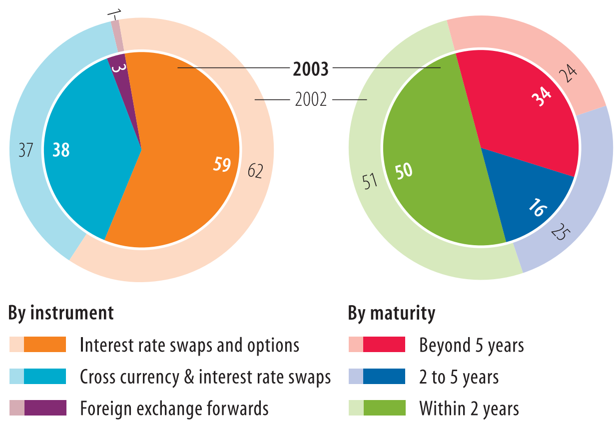
As at 31 December 2003



Use of interest rate and currency risk hedging products

MTR's active use of derivatives solely for hedging purposes reduced its interest rate and currency risk exposures.

Percentage (As at 31 December 2003)



Pursuant to the financing arrangement stipulated in the Penny's Bay Rail Link Project Agreement, the Government will waive HK$37 million, being outstanding balance of its committed financial support to the PBL Project, of its entitlement to receive the cash portion of the final dividend for the year.

Balance sheet

The Group's balance sheet remained strong, with the bulk of its assets invested in the railway system. Total fixed assets increased from HK$94,270 million in 2002 to HK$96,921 million as at 31 December 2003, mainly attributable to the receipt of the office space and car parks at Two IFC which are being used as investment properties.

Railway construction in progress increased by 66.1% from HK$109 million in 2002 to HK$181 million as at 31 December 2003, as a result of the reclassification of the Tung Chung Cable Car project cost from deferred expenditure upon signing of the project agreement.

Property development in progress represents the costs incurred in preparation of sites for property development less reimbursement already received from developers. Property development in progress at the year-end amounted to HK$2,309 million, a reduction of 19.5% from the previous year's HK$2,870 million mainly due to the transfer out of site preparation costs in respect of Two IFC upon completion in July 2003.

Debtors, deposits and payments in advance increased from HK$727 million at the 2002 year-end to HK$1,153 million as at 31 December 2003, accounted for mainly by the sale proceeds receivable from properties sold at Sorrento around year-end.

Cash and cash equivalents decreased to HK$376 million as at 31 December 2003 from HK$1,718 million as at 2002 year-end, due to the utilisation of funds for meeting capital project payments and loan repayments.

Total loans outstanding at year-end was HK$32,025 million, a decrease of HK$1,483 million compared with 2002 due to loan repayments. Loans drawn down during the year amounted to HK$7,441 million which were primarily for refinancing purpose.

Deferred income decreased from HK$6,226 million in 2002 to HK$5,061 million following profit recognition at Kowloon and Tung Chung station developments in accordance with the progress of property construction and pre-sales program.

Our share capital, share premium and capital reserve of HK$35,086 million at year-end was HK$1,176 million higher than in 2002, as a result of shares issued for scrip dividend and share options exercised. Together with increases in asset revaluation reserve of HK$270 million and retained earnings net of dividend of HK$2,272 million, total shareholders' funds increased to HK$57,292 million from HK$53,574 million (as restated) as at 31 December 2002. As a result, the Group's gross debt-to-equity ratio improved from 62.5% (as restated) to 55.9% at 2003 year-end and net debt-to-equity ratio from 59.3% (as restated) to 55.2%.

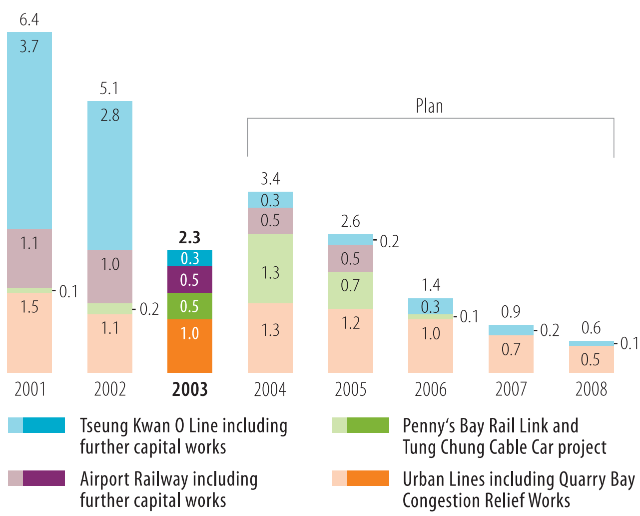
Cash flow

The net cash inflow from operating activities decreased from HK$4,228 million in 2002 to HK$3,837 million, due to lower operating profit from railway and related operations before depreciation. The main cash outflows related to capital expenditures on the Tseung Kwan O Extension, Penny's Bay Rail Link and other capital work projects amounting to HK$2,670 million, as well as net loan repayment of HK$1,362 million. Together with interest and dividends paid total outflows for 2003 amounted to HK$6,090 million. After including receipt of HK$855 million from property developers

Investment in new railway lines and the existing networks

The MTR's capital spending on new railway lines and the network is projected to be substantially lower than in recent years, leaving the Company well funded to expand through other investments.

In HK$ billion



and property purchasers, and net inflow of HK$78 million from other activities, there were net cash outflows of HK$1,320 million for the year compared to net inflows of HK$1,518 million for 2002.

Financing activities

New financings

The Hong Kong dollar market remained highly liquid throughout the year due to continued weak investment and borrowing demands. This, together with record low interest rates and investors' increasing appetite for longer term investments, presented MTR with excellent opportunities to tap the market for long term funds. During the period, we accessed the market several times and arranged a total of HK$3.1 billion in long term bonds via private placements. These comprised HK$2.3 billion in Hong Kong dollar bonds with maturities of 7 to 15 years, and a US$100 million 10-year bond. Included in the new Hong Kong dollar financings was a HK$500 million 15-year bond which was the single largest 15-year fixed rate bond ever issued into the Hong Kong dollar market. These new transactions not only enabled the Group to obtain very cost effective funding, but further extended our debt maturity profile.

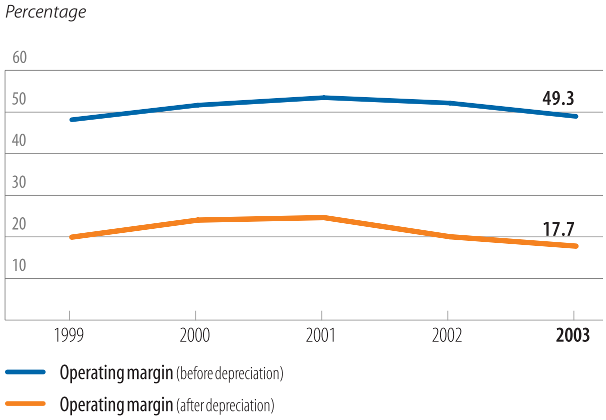
The banking market was also very liquid during the year resulting in further contraction of credit spreads. The Group took advantage of this and entered into a number of Hong Kong dollar bilateral loan facilities with some of its key relationship banks totalling HK$5.2 billion. This brought the total amount of new financings arranged for the year to HK$8.3 billion. With maturities of 5 to 7 years, these new facilities will further extend our debt maturity profile.

At the end of 2003, the Group had total undrawn committed bank loans amounting to HK$6.7 billion. These undrawn facilities together with cash on hand is expected to provide coverage for all of the Group's anticipated funding needs well into the third quarter of 2004. Following the successful launch of the Group's US$600 million 10-year Eurobond in January 2004, this financing coverage has now been further extended.

In March 2003, the Company successfully completed its first U.S. cross border leasing transaction, utilising the Airport

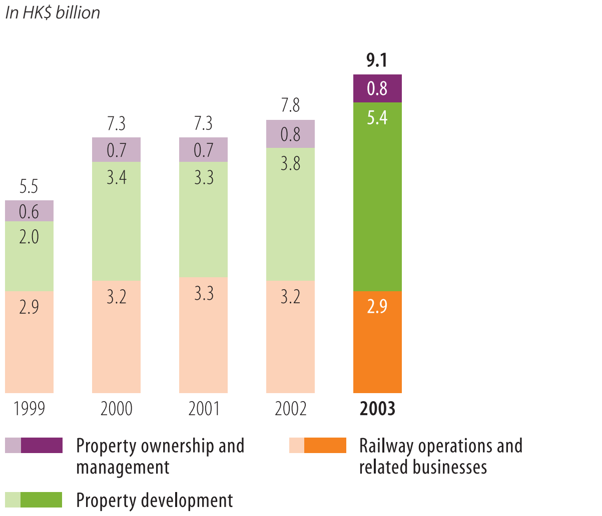
Operating margins

Lower revenues and higher operating costs following the full year operation of the Tseung Kwan O Line saw a reduction in operating margin.



Operating profit contributions

Property development made an increased contribution to operating profit, following completion of Two IFC.



Net results

The company's financial results reflected the stable growth afforded by its combined rail and property business model.