Management Discussion and Analysis

(Financial figures are expressed in Hong Kong dollars)

OVERALL PERFORMANCE

The Group recorded a profit attributable to shareholders of $505 million for the interim period (2004 first quarter: $314 million; 2004 second quarter: $191 million), compared with $214 million for the same period in 2003 (2003 first quarter: $89 million; 2003 second quarter: $125 million).

Income increased on the back of a continuing high level of activity in cash and derivatives markets in 2004, which has resulted in an increase in trading fees and trading tariff, and clearing and settlement fees in comparison with the same period in 2003. This was partly offset by a drop in investment income mainly due to reduced interest income during the period on account of lower interest rates and, in April 2004, the decline in bond and equity prices as the markets reacted negatively to concerns over interest rate hikes and macro economic measures by Mainland authorities to slow credit growth in certain sectors.

Total operating expenses for the first six months decreased by $95 million or 14 per cent to $566 million (2003: $661 million), which was mainly due to the non-recurring one-off costs incurred in 2003 ($52 million less tax deduction of $1 million) and savings in information technology and computer maintenance expenses and legal and professional fees during the current period. Taxation in 2003 also included a one-off increase in deferred tax charge of $6 million following the implementation of the new Hong Kong Statement of Standard Accounting Practice (SSAP) 12: Income Taxes and the hike in Profits Tax rate.

Income

Total income (including share of profits of associated companies) for the period increased by $263 million or 29 per cent to $1,173 million (2003: $910 million).

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Improved market sentiment, which started in the second half of 2003, continued into 2004. In spite of the anxiety brought about by the macro economic measures introduced to adjust the Mainland economy, high oil prices and the interest rate rise in the United States, which has caused trading activities on the cash market to edge down in the second quarter, the average daily turnover on the Stock Exchange for the six-month period rose by 137 per cent to $16.8 billion compared with $7.1 billion in the corresponding period last year. Average daily number of stock options contracts traded on the Stock Exchange during the first six months of 2004 increased by 60 per cent compared to the same period of 2003. Moreover, the average daily number of derivatives contracts traded on the Futures Exchange increased by 47 per cent, which was mainly attributable to the increase in the trading of Hang Seng Index (HSI) Futures contracts and the launch of H-Shares Index Futures in December 2003. Consequently, trading fees and trading tariff rose by $162 million or 88 per cent to $347 million (2003: $185 million).

Listing fee income increased by $23 million or 14 per cent to $183 million (2003: $160 million), primarily because of an increase in initial listing fees mainly arising from an increase in the number of newly listed derivative warrants to 595 in 2004 (2003: 216), and a rise in annual listing fees due to a higher number of listed securities. There were 23 (2003: 16) and 15 (2003: 12) new listings on the Main Board and GEM respectively during the six-month period ended 30 June 2004. As at 30 June 2004, 12 Main Board and five GEM (31 December 2003: three Main Board and five GEM) IPO applications had obtained approval in principle from the Listing Committees for listing, and 23 Main Board and 26 GEM applications were under processing (31 December 2003: 19 Main Board and 32 GEM). As at 30 June 2004, there were 869 companies listed on the Main Board and 199 on GEM (31 December 2003: 852 and 185 respectively).

In line with the growth in cash market activities, clearing and settlement fee income increased by 101 per cent or $94 million to $186 million in the first six months (2003: $92 million), and depository, custody and nominee services fees increased by 32 per cent or $30 million to $125 million during the six-month period ended 30 June 2004 (2003: $95 million).

Income from sale of information for the first six months increased by $33 million or 25 per cent to $159 million (2003: $126 million), as demand for information increased in tandem with the activities of cash and derivatives markets.

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Investment income comprises income from investments supervised by the Finance Department, investment in Singapore Exchange Limited and accommodation income from Participants. Total investment income for the period decreased by $98 million or 55 per cent to $80 million (2003: $178 million), predominantly due to the absence of market gains, and lower interest rates during the period.

For investments supervised by the Finance Department, income for the period amounted to $75 million, 55 per cent or $93 million lower than the $168 million for the same period in 2003. In 2003, there was a gain of $56 million, reflecting market movements in the period; in 2004, there was no net gain, again reflecting markets. Also, net interest income was lower at $72 million (2003: $110 million) due to lower interest rates.

During the period under review, the average 6-month Hong Kong Exchange Fund Bill rate dropped from 1.13 per cent in 2003 to 0.31 per cent in 2004, and the average 90-day US Treasury Bill rate declined from 1.1 per cent to 1.0 per cent.

For the six months ended 30 June 2004, the Finance Department achieved a positive return on investments of 1.06 per cent (2003: 3.64 per cent). The Corporate Funds returned 1.92 per cent (2003: 5.31 per cent), the margin funds 0.67 per cent (2003: 1.90 per cent), and the Clearing House Funds 0.64 per cent (2003: 2.15 per cent). Therefore, the overall portfolio recorded a spread of 75 basis points (2003: 251 basis points), with Corporate Funds registering a spread of 161 basis points (2003: 418 basis points), the margin funds 36 basis points (2003: 77 basis points) and the Clearing House Funds 33 basis points (2003:102 basis points) above the 6-month Hong Kong Exchange Fund Bill yield.

The average amount of funds available for investment during the period increased by 55 per cent or $5.1 billion to $14.3 billion (2003: $9.2 billion), primarily due to a rise in margin funds received from Participants as a result of increased open interest in futures and options contracts, which was partly offset by the reduction in Corporate Funds following the $2.2 billion payment of 2003 special and final dividends on 14 April 2004. As at 30 June 2004, 52 per cent (31 December 2003: 59 per cent) of the funds were invested in cash and bank deposits, 46 per cent (31 December 2003: 39 per cent) in high-grade bonds with an average credit rating of Aa2, and 2 per cent (31 December 2003: 2 per cent) in global equities. For more details of the investment portfolio, please refer to the Finance section under Review of Operations.

Accommodation income (i.e. retention interest charged on cash margin deposits in non-contract settlement currencies and securities deposited by Participants as alternatives to cash deposits of the margin funds) decreased by 56 per cent or $5 million to $4 million (2003: $9 million). Income from the investment in Singapore Exchange Limited for the first six months increased by $0.1 million or 20 per cent to $0.8 million (2004: dividend of $1.1 million less foreign exchange loss of $0.2 million and interest expense of $0.1 million for funding the investment; 2003: dividend of $1.0 million, foreign exchange gain of $0.1 million less interest expense of $0.4 million). The investment in Singapore Exchange Limited was disposed of in July 2004 at a profit over cost of $24.8 million.

Other income increased by $16 million or 22 per cent to $87 million (2003: $71 million), mainly due to a $8 million increase in brokerage on direct IPO applications, and an increase in terminal, dataline and network usage fees and software sub-license fees of $7 million.

Share of profits of associated companies increased by $3 million or 89 per cent to $6 million (2003: $3 million), due to the improved performance of one of the associated companies, Computershare Hong Kong Investor Services Limited, during the period under review.

Operating Expenses

Total operating expenses for the period under review decreased by 14 per cent or $95 million to $566 million (2003: $661 million).

Staff costs and related expenses decreased by 3 per cent or $8 million to $259 million (2003: $267 million), largely due to the $9 million of one-off severance costs incurred following the reorganisation and streamlining of the Group's operations in May 2003. Savings in salaries as a result of reduced headcount was offset by an accrual for performance bonus on account of the Group's improved performance in 2004.

Information technology and computer maintenance expenses for the first six months fell by $27 million or 20 per cent to $110 million in 2004 (2003:$137 million), mainly attributable to lower hardware and software rental. During the period under review, capital expenditures on computer systems, hardware and software amounted to $11 million (2003: $16 million).

Premises expenses fell by 9 per cent or $4 million to $39 million (2003: $43 million) as lower rental was negotiated upon the renewal of certain leases and savings from reduced floor area leased during the first six months of 2004.

Product marketing and promotion expenses increased by $2 million or 70 per cent to $6 million (2003: $4 million). The increase was mainly attributable to the advertising campaigns and incentive programmes launched for the introduction and promotion of the H-shares Index Futures and H-shares Index Options.

Legal and professional fees for the period decreased by $16 million or 74 per cent to $5 million (2003: $21 million). The decrease was mainly attributable to professional fees incurred for several one-off consulting projects in the first half of 2003.

Depreciation and amortisation costs remained fairly stable at $93 million (2003: $93 million). The increase in depreciation attributable to the rollout of DCASS in April 2004 was offset by the decrease as a result of revising the estimated useful life of the hardware of trading and clearing systems from three years to five years to better reflect the useful life of the equipment.

Payment to the SFC was $10 million for the first six months of 2004 (2003: $5 million) under the dual filing regime, which started from 1 April 2003.

Other operating expenses dropped by $47 million or 52 per cent to $44 million (2003: $91 million), mainly attributable to certain one-off costs incurred in 2003 ($32 million for the write-down of the Group's investment in BondsInAsia Limited and $10 million of retirement of redundant IT systems following the review of its business strategy and operations in May 2003), as well as a devaluation deficit of $4 million of one of the Group's properties charged to the profit and loss account in 2003. Provision for doubtful debts fell by $3 million or 96 per cent compared with 2003.

Taxation

The Group's taxation charge rose by $67 million or 191 per cent to $102 million (2003: $35 million), principally by reason of a $62 million rise in tax charge arising from an increase in profit before taxation in 2004, a $11 million increase in tax charge due to a lower deferred tax credit from utilisation of tax losses of certain entities of the Group, but partly offset by a one-off deferred tax charge of $6 million recognised in 2003 due to an increase in tax rate from 16.0 per cent in 2002 to 17.5 per cent in 2003 and the first time adoption of SSAP 12: Income Taxes, effective from 1 January 2003.

Comparison of 2004 second quarter performance with 2004 first quarter results

Profit attributable to shareholders was $191 million for the second quarter of 2004, $123 million or 39 per cent lower than the $314 million registered in the first quarter of 2004. The reduction was mainly attributable to a $130 million or 20 per cent reduction in income. Investment income fell from $93 million in the first quarter to a negative $13 million in the second quarter mainly due to the fall in the bond and equity markets and exchange losses which occurred in April. The decline in activities of the cash market in the second quarter has also led to a decrease in trading fees and trading tariff of $38 million and clearing and settlement fees of $27 million compared with the first quarter. The decrease was partly offset by $50 million of higher depository, custody and nominee services fee on account of an increase in dividend collection and scrip fee income.

Total operating expenses has remained fairly stable at $282 million for the second quarter of 2004 (first quarter of 2004: $283 million).

Tax charge fell by $7 million mainly due to a decrease of $22 million in tax charge arising from lower profit before taxation in the second quarter, which was partly offset by an additional tax charge of $5 million due to reduced non-taxable income net of expenses, and a $10 million rise in tax charge due to a lower deferred tax credit from utilisation of tax losses of certain entities of the Group in the second quarter.

Liquidity, Financial Resources and Capital Commitments

Working capital fell by $1,319 million or 32 per cent to $2,751 million as at 30 June 2004 (31 December 2003: $4,070 million). The decline was primarily due to the payment of the 2003 special and final dividends of $2,219 million in April 2004, which was partly offset by a reduction in time deposits with maturity over one year and the profit generated during the period.

Although the Group has consistently been in a very liquid position, banking facilities have nevertheless been put in place for contingency purposes. As at 30 June 2004, the Group's total available banking facilities amounted to $2,763 million (31 December 2003: $2,764 million), of which $1,500 million were repurchase facilities to augment the liquidity of the margin funds and $1,100 million were for meeting the Group's Continuous Net Settlement money obligations of HKSCC in the CCASS in circumstances where CCASS Participants default on their payment obligations. Borrowings of the Group have been very rare and, if required, are mostly event driven, with little seasonality. As at 30 June 2004, the Group did not have any bank borrowings (31 December 2003: S$11 million, equivalent to HK$50 million, with a maturity of less than 1 year was used for the purpose of hedging the currency exposure of the Group's investment in Singapore Exchange Limited).

As at 30 June 2004, the Group had zero gearing (31 December 2003: gearing ratio, measured on the basis of total borrowings as a percentage of total shareholders' equity, was less than 1 per cent).

As at 30 June 2004, the Group's capital expenditure commitments, mainly in respect of its ongoing investments in facilities and technology, amounted to $49 million (31 December 2003: $91 million). The Group has adequate financial resources to fund its commitments on capital expenditures from its existing cash resources and cash flows generated from its operations.

As at 30 June 2004, 94 per cent (31 December 2003: 98 per cent) of the Group's cash and cash equivalents (comprise cash on hand, bank balances and time deposits within three months of maturity when acquired) were denominated in HKD and USD.

Charges on Assets

The Group did not have any charges on assets as at 30 June 2004 and 31 December 2003.

Significant Investments Held and Material Acquisitions and Disposals of Subsidiaries

The Group has been holding 1 per cent of the issued ordinary share capital of Singapore Exchange Limited since November 2000 (cost: $49.1 million; and market value: $76.1 million), 24 per cent of Computershare Hong Kong Investor Services Limited since May 2002 (cost: $26.5 million; and book value: $31.5 million) and 30 per cent of ADP Wilco Processing Services Limited since May 2002 (cost: $1.8 million; and book value: $1.3 million).

There were no material acquisitions or disposals of investments and subsidiaries during the six-month period but the investment in Singapore Exchange Limited was disposed of in July 2004.

Exposure to Fluctuations in Exchange Rates and Related Hedges

When seeking to optimise returns on its funds available for investment, the Group may invest in non-HKD securities from time to time. During the period, the Singapore dollar credit facility (31 December 2003: S$11 million or HK$50 million) used to hedge the currency exposure of the Group's investment in shares of Singapore Exchange Limited was fully repaid. Thereafter, only forward foreign exchange contracts are used to hedge the currency exposure of the Group's non-HKD investments to mitigate risks arising from fluctuations in exchange rates. As at 30 June 2004, aggregate net open foreign currency positions amounted to HK$1,679 million, of which HK$207 million were non-USD exposures (31 December 2003: HK$1,663 million, of which HK$204 million were non-USD exposures). The Group's foreign currency liabilities, in the form of margin deposits or collateral received, are hedged by investments in the same currencies.

Contingent Liabilities

The Unified Exchange Compensation Fund (Compensation Fund) is a fund set up under the repealed Securities Ordinance (SO) for the purpose of compensating any person dealing with a Stock Exchange Participant (other than another Stock Exchange Participant) for any pecuniary losses suffered as a result of a default of the Stock Exchange Participant. According to section 109(3) of the SO, the maximum compensation amount is $8 million for each Stock Exchange Participant's default. Under section 113(5A) of the SO, the Stock Exchange may, upon satisfying certain conditions, with the approval of the SFC, allow an additional payment to the successful claimants before apportionment. Under section 107(1) of the SO, the Stock Exchange has contingent liabilities to the Compensation Fund as it shall replenish the Compensation Fund upon the SFC's request to do so. The amounts to be replenished should be equal to the amount paid in connection with the satisfaction of the claims, including any legal and other expenses paid or incurred in relation to the claims but capped at $8 million per default. As at 30 June 2004, there were outstanding claims received in respect of 12 defaulted Stock Exchange Participants (31 December 2003: 13).

Pursuant to the SFO, the Stock Exchange issued a notice on 3 April 2003 inviting for claims against the Compensation Fund in relation to any default of a Stock Exchange Participant occurring before 1 April 2003. The claims period expired on 3 October 2003 and no claims had been received in response to that notice. Claims made after the claims period shall, unless the Stock Exchange otherwise determines, be barred. Until 30 June 2004, no claims had been received.

Following the implementation of the new compensation arrangements under the SFO, an Investor Compensation Fund has been established to replace the existing Compensation Fund, the Commodity Exchange Compensation Fund and the Dealers' Deposit Schemes for non-exchange participant dealers. Pursuant to the SFO, Exchange Participants are no longer required to make deposits to the Investor Compensation Fund and the Stock Exchange is not required to replenish the Investor Compensation Fund. Hence, deposits to the Commodity Exchange Compensation Fund had been returned to the Futures Exchange by the SFC in January 2004. The Futures Exchange had in turn reimbursed holders of Futures Exchange Trading Rights their contributions to the Commodity Exchange Compensation Fund. Similarly, deposits to the Compensation Fund would be returned to the Stock Exchange in accordance with the SFO pending completion of the determination of the outstanding claims and replenishment to the Compensation Fund.

The Stock Exchange has undertaken to indemnify the Collector of Stamp Revenue against any loss of revenue resulting from any underpayment or default or delay in payment of stamp duty by its Participants, up to $200,000 in respect of default of any one Participant. In the unlikely event that all of its 436 trading Participants as at 30 June 2004 (31 December 2003: 437) default, the maximum contingent liability of the Stock Exchange under the indemnity will amount to $87 million (31 December 2003: $87 million).

HKEx gave an undertaking on 6 March 2000 in favour of HKSCC to contribute an amount not exceeding $50 million in the event of HKSCC being wound up while it is a wholly-owned subsidiary of HKEx or within one year after HKSCC ceases to be a wholly-owned subsidiary of HKEx, for payment of the debts and liabilities of HKSCC contracted before HKSCC ceases to be a wholly-owned subsidiary of HKEx, and for the costs, charges and expenses of winding up.

Employees

HKEx has developed its human resources policies and procedures based on performance and merit. The Group ensures that the pay levels of its employees are competitive and employees are rewarded on a performance-related basis within the general framework of the Group's salary and bonus system.

Share options may further be granted to Chief Executive and employees of the Group to subscribe for shares in HKEx in accordance with the terms and conditions of the Post-Listing Share Option Scheme approved by the shareholders of HKEx at an extraordinary general meeting held on 31 May 2000.

Following the merger of the businesses of the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group in 2000, HKEx has succeeded in streamlining its workforce and the number of employees fell from 1,052 (including 88 temporary staff) prior to the merger to 780 (including 31 temporary staff) as at 30 June 2004. For the two semi-annual periods under review, total employees' cost decreased by 3 per cent to $259 million (2003: $267 million), mainly due to one-off severance costs incurred following the reorganisation and streamlining of the Group's operations in May 2003.

There are no significant changes to the policies relating to remuneration, bonus, share option schemes and training schemes from the information disclosed in the 2003 annual report.

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PROSPECTS

As a substantial part of HKEx's income comprises trading fees, clearing and settlement fees, listing fees and interest income, the performance of the Group is heavily affected by external factors including, in particular, market sentiment, the level of activity on the Stock Exchange and the Futures Exchange, and movements in interest rates.

Following the significant rebound in trading volume on the securities market, which started in the second half of 2003, trading appears to have peaked temporarily in the first quarter of 2004 before easing back to a level similar to that of the third quarter of 2003, as investors watched from the sidelines the likely impact of the macro economic adjustments in Mainland China, high oil prices and the beginning of a rising interest rate cycle in the United States. It is likely that market sentiment will continue to be affected by the uncertainties created by these issues.

HKEx will continue to exercise stringent control over its costs and target its resources at market needs. It will strive to improve the quality of its markets by strengthening market supervision and risk management, and adopting more world-class regulatory practices and market infrastructure. The revised organisational structure announced in May 2004 will further improve HKEx's efficiency and strengthen its regulatory, risk management and market operations.

HKEx will continue to develop new products and services to diversify revenue sources and attract more high quality companies to list in Hong Kong. It will also remain focused on seizing opportunities arising from the economic reform and development in Mainland China. These efforts will be supported by the recent stationing of representatives in Guangzhou and Shanghai, which enables HKEx to have a wider reach as it seeks potential listing candidates in these two key economic zones of Mainland China. With the concerted efforts of the Government, supervisory bodies and professional market practitioners to jointly promote its securities and derivatives markets, Hong Kong is well positioned to capitalise on the immense opportunities brought about by Mainland China's economic growth and strengthen its position as a major international financial centre in the region.