



CHAPTER 2

PUTTING THE RIGHT PIECES TOGETHER

HAVING ESTABLISHED
A FIRM FOOTHOLD IN THE MASS MARKET,
WE WILL LOOK TOWARDS
EXPANDING OUR BRAND REPUTATION
TO INCLUDE
HIGHER VALUE ADDED SERVICES
AS WELL AS
ATTRACTIVE PRICING,
AND TO BUILD UPON
TRADITIONAL MASS MARKET FOCUS.

MANAGEMENT'S DISCUSSION AND ANALYSIS

FINANCIAL REVIEW

Results of Operation

	2004	2003
Year ended 31st August	HK\$000	HK\$000
Revenues		
International telecommunications services (IDD)	627,978	875,802
Fixed telecommunications network services (FTNS)	541,902	423,107
	1,169,880	1,298,909
Operating profit*	51,768	276,201
Finance costs	(175)	(601)
Profit before tax	51,593	275,600
Tax	(2,043)	(17,857)
Profit attributable to shareholders	49,550	257,743
EBITDA*		
International telecommunications services	186,851	370,660
Fixed telecommunications network services	58,180	78,398
	245,031	449,058

* Included USC adjustment for HK\$31,689,000 and HK\$84,119,000 for fiscal 2004 and 2003 respectively.

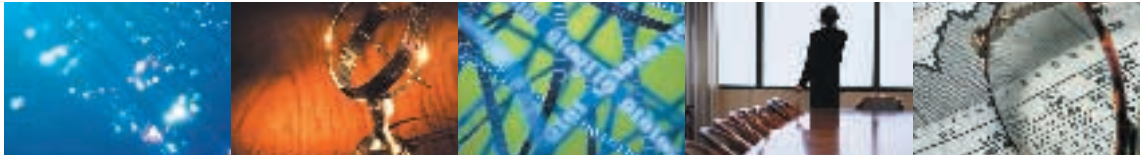
The 12 months ended 31st August 2004 was challenging in that the IDD business remained intensely competitive while the FTNS business had yet to mature enough to fully compensate for the decline in our IDD revenues. During the year, we aggressively marketed our FTNS services, and saw our subscription base increased from 312,000 to 465,000. Launched in May 2004, our "Dodo" Home Telephone with free appliance promotion was a success, and enabled us to capture significant market share. Within our 1.2 million homes passed, our 220,000 residential voice subscribers represent approximately 18% addressable market share which compares with the incumbent's overall residential market share of approximately 70%. While customer acquisition costs dragged down our earnings this year, we expect each subscriber to generate a positive free cash flow over the lifetime of their 2-3 year fixed term contracts. Furthermore, the voice subscriptions form a base for us to up-sell our multiple service offerings such as IDD, broadband Internet access, IP-TV and CTIMall.

Profit attributable to shareholders was HK\$50 million for this year, representing a drop of 81% compared to HK\$258 million

last year. We received a USC rebate of HK\$32 million in fiscal 2004, compared to a USC rebate of HK\$84 million in fiscal 2003.

We have historically paid higher aggregate USC fees to PCCW-HKT based on provisional rates stipulated by OFTA than the rates ultimately determined by OFTA to be due, and therefore have received a USC refund in each year since 2002. However, the uncertainty surrounding OFTA's calculation of the USC charge means that we cannot be sure whether we will receive such refunds in future periods, or what the size of any such refunds may be.

Total revenue fell 10% to HK\$1,170 million, due to the fall in our IDD revenues. The 28% increase in our FTNS revenues to HK\$542 million was not sufficient to offset the 28% decrease in our IDD revenue to HK\$628 million. However, our revenue mix has improved with contribution from the FTNS segment now at 46% for this year, compared to 33% last year. FTNS revenues have surpassed IDD revenues in each month since July 2004.



The FTNS segment, with fixed contract terms and higher gross profit margins, helped to maintain our gross profit margin (excluding the USC rebate) at a healthy level of 69%, unchanged versus last year, despite a significant fall in IDD profitability.

Total operating costs for our IDD business (excluding the USC rebate) dropped by 20% to HK\$503 million in fiscal 2004 compared to HK\$626 million in fiscal 2003. For FTNS, total operating costs increased by 34% to HK\$653 million compared to HK\$488 million last year. The major drivers of the FTNS cost increase were a 51% increase in marketing costs to HK\$156 million together with HK\$44 million in start-up costs incurred by our IP-TV business to reach commercial status.

As a result of the above, our operating profit (excluding the USC rebate) was HK\$20 million this year, down from HK\$192 million profit last year. Our IDD business recorded a 49% decrease in operating profit to HK\$130 million in fiscal 2004

from HK\$255 million in fiscal 2003 while our FTNS business increased its operating loss to HK\$110 million from a loss of HK\$63 million in fiscal 2003.

Excluding USC rebates of HK\$32 million and HK\$84 million, net profit attributed to shareholders for fiscal 2004 and fiscal 2003 was HK\$18 million and HK\$174 million respectively.

Liquidity and Capital Resources

As of 31st August 2004, the Group had cash and bank balances of approximately HK\$290 million and outstanding borrowings of HK\$119 million. Capital expenditure incurred during the year was HK\$410 million, the majority of which, approximately HK\$393 million, was invested in our local fixed telecommunications network. Our network development will require ongoing capital expenditure, and we are exploring various options to meet this requirement.

A summary of our outstanding borrowing as of 31st August 2004 and 31st August 2003 follows:

	31 August 2004	31 August 2003
	HK\$000	HK\$000
Repayable within one year	32,503	18,174
Repayable in the second year	20,000	–
Repayable in the third to fifth year	60,000	–
Repayable after the fifth year	6,667	–
Total	119,170	18,174

The currency denomination for the borrowings was as follows:

	31 August 2004	31 August 2003
	HK\$000	HK\$000
Hong Kong Dollars		
– Secured	100,000	–
Japanese Yen		
– Secured	19,170	18,174
Total	119,170	18,174



As of 31st August 2004, all of our outstanding borrowings bore floating interest rates except for a HK\$100,000,000 long-term bank loan for which we entered into an interest rate swap arrangement to hedge the associated interest rate risk. As our cash and bank balances exceeded all outstanding borrowings as of 31st August 2004, no gearing ratio has been presented.

Charge on group assets

As of 31st August 2004, the HK\$100,000,000 long-term bank loan was secured by a fixed and floating charge over all assets of Hong Kong Broadband Network Limited, our wholly owned subsidiary. A short-term bank loan of HK\$19,170,000 was secured by a bank deposit of the same amount. In addition, certain bank guarantees provided to suppliers and to utility vendors in lieu of payment of utility deposits were secured by pledged bank deposits of US\$800,000 and HK\$1,395,000, and a charge over an investment with a market value of US\$468,000 as of 31st August 2004 (compared to pledged bank deposits of HK\$11,434,000 as of 31st August 2003).

Exchange rates

During the year, the Group was not affected to any significant extent by fluctuations in exchange rates.

Contingent liabilities

As of 31st August 2004, the Group had total contingent liabilities in respect of guarantees provided to suppliers of HK\$6,295,000 (compared to HK\$7,812,000 as of 31st August

2003) and to utility vendors in lieu of payment of utility deposit of HK\$3,622,000 (compared to HK\$3,622,000 as of 31st August 2003).

BUSINESS REVIEW

Fixed Telecommunications Network Services (FTNS)

During fiscal year 2004 we grew our subscription base for local voice over IP, broadband and IP-TV by 153,000 to a total of 465,000 subscribers. Our key focus for the year was to establish a strong foothold in the voice segment as the incumbent operator became more aggressive in signing its voice customers to 12-18 month retention programs. During the year, we modified voice acquisition strategy from being focused principally on price to emphasizing our quality of service, and signing our customers to longer term service contracts of 24-36 months. While this acquisition strategy may have a cost to us in the near term, we believe it will pay dividends in the longer term with lower churn rates and lower retention costs, as well as set the foundation for up-selling of additional services over time.

For our broadband and local voice over IP services, we managed a respectable positive EBITDA of HK\$98 million in fiscal 2004, a 24% growth compared to fiscal 2003, and increased our average contract lock-up periods. However, our start-up IP-TV service incurred an EBITDA loss of HK\$39 million as the subscriber base has yet to reach critical mass to cover the fixed costs attributable to our IP-TV services.

Local Voice over IP, Broadband Internet access and IP-TV Subscriptions

('000)	31st August 2003	31st August 2004	YoY %	Monthly Additions
Subscriptions				
Broadband	172	197	19%	2.1
Local Voice over IP	140	237	167%	8.1
IP-TV	-	31	na	2.6
Total subscriptions ('000)	312	465	69%	12.8



International Telecommunications Services (IDD)

Despite aggressive pricing strategies employed by our competitors, CTI maintained a 21% market share in terms of outgoing volume. CTI carried a total 1,007 million IDD minutes, which is a 13% increase over 888 million minutes delivered last year. The top three routes accounted for 82% of total traffic with China at 70%, USA at 7% and Canada at 5%. Serious market competition drove down the tariff rate by 37% year on year to an average of HK\$0.62 per minute in fiscal 2004. However, the rate of decline in average IDD rates has slowed in the second half of fiscal 2004.

PROSPECTS

With our all-IP network foundation now in place, our efforts in 2005 and 2006 will be to focus on executing our committed expansion of home-pass coverage from 1.2 million to 1.6 million (approximately 75% of Hong Kong's total households) and corporate buildings from 600 to 1,200. Our November launch of "BB100" broadband Internet service, which provides symmetric 100 Mbps access, showcases our inherent network advantages over xDSL and cable modem networks. Having established a firm foothold in the mass market, we will look towards expanding our brand reputation to include higher value added services as well as attractive pricing, and to build upon our traditional mass market focus.

Our corporate business segment may not command as much public profile as our residential service, but is a core contributor of our overall business. With a strategic focus on Small-to-Medium-Enterprises (SME), our dedicated corporate team of over 400 staff services 60,000 active accounts that contribute 43% of our total IDD revenues. Working in partnership with our primary vendors Cisco Systems and Nortel Networks, our corporate team endeavors up-sell higher value added services such as IP-Centrex to our corporate clients.

To date, our subscriber acquisition strategy has focused on new customers using either the broadband or local voice over

IP service as an initial entry point into the home. Now that we have accumulated a registered base of 1.9 million registered accounts and over 500,000 active accounts using our service, we intend to cultivate this database with proactive up selling services, by leveraging our Guangzhou call center capabilities. In this regard, we believe our investment in our Guangzhou call center will significantly lower our subscriber acquisition costs.

Delivery and management of content is a critical element in our broadband strategy. We are pleased by the progress of our IP-TV operation which has grown from an upstart of 40 staff at the beginning of fiscal year 2004 to a critical mass of 160 currently. With a Chinese language centric content offering for the mass market, we hope to simulate overall Pay-TV penetration and to nurture closer cultural integration between Hong Kong and China.

EMPLOYEE RELATIONS

As of 31st August 2004, the CTI Group had approximately 3,571 permanent full-time employees, of which 1,598 were stationed in Hong Kong and 1,956 were located in Guangzhou. The total staff related cost was approximately HK\$227 million for fiscal year 2004. CTI Group offers remuneration packages consisting of basic salary, bonus and other benefits. Bonus payments are discretionary and dependent on performance of both CTI Group and the individual employee. In addition to the comprehensive medical and life insurance coverage, CTI Group provides share options as well as competitive retirement benefits.

To improve the quality and productivity of our personnel, we offer over 70 types of training programs and learning activities. These include programs that focus on our technology, business operations and management skills, and total participation amounted over 17,560 man-days in fiscal 2004.