MANAGEMENT'S DISCUSSION AND ANALYSIS

Overall operations review

Turnover increased by 9.2% to HK$613 million (2004: HK$562 million). The increase in retail and residential rental income (retail: 14.3%, residential: 30.5%) have balanced off the decrease of 1.4% in office rental income. Office rental reversions also began to turn positive during the review period.

Office leasing – Against a backdrop of positive market sentiment, the office leasing market continued to be active with businesses expanding and upgrading. The Group benefited from the increased market activities in terms of higher rental levels achieved for new leases and renewals. The resulting positive rental reversions are expected to translate into earnings growth in 2006.

Retail leasing – The retail market remained active on the back of increased local consumption and tourist arrivals. Driven by the increase in retail sales, prime retail properties were in demand which in turn drove up rental levels.

The Group's retail portfolio continued to enjoy the advantage of its strategic location in the heart of Causeway Bay's prime office and retail hub with retail space virtually fully let and increased rental levels. The overall increase in retail sector rental income was attributable mainly to the contributions from the repositioned Lee Gardens Two, and rental increases for new leases.

The Group is continuing its longer-term asset enhancement programme to create value for its investment properties through selective re-tenanting, physical improvements, renovation and repositioning. This includes the repositioning of Lee Theatre Plaza to strengthen its speciality food and beverage character.

Residential leasing – The luxury residential leasing market continued to be active with an increasing number of expatriate arrivals.

The Group's residential rental income increased by some 30% largely driven by higher occupancy and rental levels at the repositioned Bamboo Grove.

Property expenses – There was a decrease of 12.4% to HK$106 million compared with HK$121 million recorded in prior period. The main factors behind such decrease were lower marketing and promotional expenses required after the re-opening of Lee Gardens Two in May 2004 as well as lower leasing-related expenses.

Other operating income increased by HK$8 million (60.2%) to HK$21 million (2004: HK$13 million) attributable to higher dividend received from the investment in listed securities.

Administrative expenses increased by HK$6 million (16.5%) to HK$45 million (2004 restated: HK$39 million), largely due to the increase in staff costs as a result of human resources up-skilling and pay rise in line with market trend.

Fair value changes on investment properties – The Group has elected the fair value model for investment properties under the HKAS 40. As at 30 June 2005, the investment properties of the Group were revalued at HK$30,761 million (31 December 2004 restated: HK$27,917 million) by an in-house professional valuer. This valuation has been reviewed and endorsed by Knight Frank Hong Kong Limited, an independent professional valuer. Excluding reclassifications and additions, fair value gains of investment properties of HK$2,799 million were recognised to the consolidated income statement during the period (the Group's share after minority interests was HK$2,619 million).

Fair value changes on financial instruments – Fair value gains of HK$23 million representing mainly gains arising from hedging currency swaps were recognised to the consolidated income statement.

Share of results of associates increased by HK$6 million (41.3%) to HK$20 million (2004 restated: HK$14 million) driven principally by improved results from the Singapore Amaryllis Ville (Group interest: 25%) with over 76% of residential units already sold. Leasing activities of Phase 1 of The Shanghai Grand Gateway, in which the Group has an effective interest of 23.7%, performed well during the period. For the Phase 2 development, occupancy permits for the office buildings were obtained. Construction of the luxury residential and service apartment towers, Grand Gateway Garden II, is underway and expected to be completed in 2006.

Finance costs – The increase of HK$13 million (15.8%) to HK$91 million (2004: HK$78 million) was mainly due to the rise in market interest rates. Short term interest rate for Hong Kong dollar borrowings rose by 3% during the period under review. However, with the close monitoring and active managing of the liquidity position and interest rate exposure, the Group was able to achieve weighted average borrowing costs of 3.05% during the period, up from 2.45% in the first half of 2004 and 2.54% for 2004 full year.

Taxation – There was a sharp increase in tax provision from HK$87 million to HK$502 million during the period, principally due to deferred tax provision relating to fair value gains on investment properties.

Contingent liabilities

There was no significant change since the publication of the Group's Annual Report 2004 in March 2005.

Capital expenditure

The Group is committed to enhancing the quality of its investment properties. Expenditure on refurbishment, renovation and additions to investment properties amounted to HK$14 million during the period.

The Group considers that there are sufficient financial resources to fund the level of planned capital expenditure. These are generated from operating activities, liquidity available from the pool of listed securities and access to the Medium Term Note Programme and availability of undrawn committed banking facilities.

Financial management

The key objective of the Group's financial management is to maintain prudent liquidity and financial risks management. This is achieved by way of an even spread of debt maturity to minimise funding and refinancing risks; diversified funding sources; and minimising interest rate and foreign exchange exposures.

Liquidity

As at 30 June 2005, the Group's total gross debt level stood at HK$5.59 billion, slightly lower than the HK$5.61 billion as at 31 December 2004. With the short-term Hong Kong dollar interest rates increased by 3% during the review period, the Group's weighted average borrowing costs (including the effect of hedging instruments) rose to 3.05% from 2.54% as at 2004 year-end.

The Group's average debt maturity was about 5.3 years (repayable within one to five years: 48%, over five years: 52%). After the issuance of the 15-year zero-coupon notes in February 2005 with the notional amount of HK$430 million, the proportion of capital market financing has increased to 41.4% of the Group's total debts. Nevertheless, bank loans which accounted for the remaining 58.6% of the total debts continued to be the major source of the debt financing to the Group.

All of the Group's debts are unsecured and on a committed basis. As a policy to maintain sufficient liquidity for the Group's operations, undrawn committed facilities of HK$2.8 billion were maintained as at 30 June 2005 (31 December 2004: HK$2.3 billion).

Risk management

The Group has positioned itself for an upturn of the interest cycle by hedging part of the floating-rate exposure with appropriate derivatives. No significant change has been made in the hedging position in the first half of 2005. As at 30 June 2005, about 49.1% of the total debts were on floating rates, largely the same as that as at 31 December 2004.

The Group's foreign exchange risk was minimal. All Group debts were either denominated in, or hedged back into, Hong Kong Dollars or the currency of the underlying assets. The Group's foreign exchange exposure relating to overseas joint ventures as at 30 June 2005 was HK$966 million, or about 2.9% of the Group's assets (91.4% of such exposure was denominated in Renminbi, with the balance being in Singapore dollars).

The investments in listed securities continued to serve as liquidity buffer to meet capital expenditure and investment needs. The Group may enter into hedging contracts by using suitable financial instruments to protect the downside risks associated with the price movement due to the timing of anticipated expenditure.

Financial ratios and credit ratings

Net interest coverage ratio (defined as profit before taxation excluding finance costs, fair value changes on financial instruments and investment properties, share of results of associates, depreciation, dividend and interest income, divided by net interest expenses less dividend income) was 7.2 times as at 30 June 2005 (31 December 2004: 7.3 times).

Net gearing (defined as gross debt less cash and cash equivalents and marketable securities at period-end market value, divided by Adjusted shareholders' funds) as at 30 June 2005 was 18.0% (31 December 2004: 20.8%).

Credit ratings as at 30 June 2005 remained unchanged, being Baa1 from Moody's and BBB from Standard and Poor's.