Credit Analysis

Introduction

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Treasury Management

Structure and Policy

Swire Pacific's Head Office Treasury sets financial risk management policies in accordance with policies and procedures approved by its Board. It also manages the majority of the group's funding needs and currency, interest rate, credit and event risk exposures. Within the same policy framework, operating subsidiaries manage currency, interest rate and commodity exposures that are specific to particular transactions within their businesses. It is the policy of the Swire Pacific group not to enter into derivative transactions for speculative purposes.

The group's listed associated companies, Cathay Pacific and HAECO, arrange their financial and treasury affairs on a stand-alone basis, in a manner consistent with the overall policies of the group.

Non-listed associated and jointly controlled companies also arrange their financial and treasury affairs on a stand-alone basis. Swire Pacific provides financial support by way of guarantees in cases where significant cost savings are available and risks are acceptable.

Interest Rate Exposure

The level of fixed rate debt for the group is decided after taking into consideration the potential impact of higher interest rates on profit, interest cover and the cash flow cycles of the group's businesses and investments.

In addition to raising funds on a fixed rate basis, the group uses interest rate swaps in the management of its long-term interest rate exposure. It also uses forward rate agreements to manage its exposure to short-term interest rate volatility.

Occasionally, the group also enters into fixed-to-floating interest-rate swaps to hedge the fair value interest-rate risk arising where it has borrowed at fixed rates in excess of its requirements.

As the group has no significant interest-bearing assets, its income and operating cash flows are substantially independent of changes in market interest rates.

Currency Exposure

The group operates internationally and is exposed to foreign exchange risk arising from various currency exposures. Foreign exchange risk arises from future commercial transactions, recognised assets and liabilities, and net investments in foreign operations.

Exposure to movements in exchange rates on individual transactions is minimised using forward foreign exchange contracts where active markets for the relevant currencies exist. All significant foreign currency borrowings with a fixed maturity date are covered by appropriate currency hedges.

Translation exposure arising on consolidation of overseas net assets is reduced, where practicable, by matching assets with borrowings in the same currency. Substantial proportions of the revenues, costs, assets and liabilities of the group are denominated in Hong Kong dollars.

The long-term financial obligations of Cathay Pacific have been arranged primarily in currencies in which it has substantial positive operational cash flows, thus establishing a natural currency hedge. The policy adopted requires that anticipated surplus foreign currency earnings should be at least sufficient to meet the foreign currency interest and principal repayment commitments in any year.

Equity Price Risk

The group is exposed to equity securities price risk in regard to investments held as available-for-sale.

Commodity Exposure

Group companies that have underlying exposures to commodity risk use derivatives including swaps, forwards and options in the management of these exposures.

Credit Exposure

When depositing surplus funds or entering into derivative contracts, the group controls its exposure to non-performance by counterparties by transacting with investment grade counterparties, setting approved counterparty limits and applying monitoring procedures. The group is not required by its counterparties to provide collateral or any other form of security against any change in the market value of a derivative. There are no specific conditions that would require the termination of derivative contracts should the credit rating of Swire Pacific be downgraded.

Derivatives

It is the group's policy not to enter into derivative transactions for speculative purposes. Derivatives are used solely for management of an underlying risk and the group is not exposed to market risk since gains and losses on the derivatives are offset by losses and gains on the assets, liabilities or transactions being hedged.

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently remeasured at their fair value. The method of recognising the resulting gain or loss depends on whether the derivative is designated as a hedging instrument and, if so, the nature of the item being hedged.

When the group enters into a derivative contract, the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions is documented. At inception and on an ongoing basis the derivatives that are used in hedging transactions are assessed to ensure that they are highly effective.

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the profit and loss account, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognised in equity. The gain or loss relating to the ineffective portion is recognised immediately in the profit and loss account.

Certain economic hedges that the group entered into prior to the release of HKAS 39, do not meet its hedge recognition criteria. Changes in the fair value of any derivative instruments that do not qualify for hedge accounting are recognised immediately in the profit and loss account.

Derivative transactions entered into by the group and outstanding at the year end are summarised and set out in Note 22 to the Accounts on page 109 by their respective types.

Credit Profile

Swire Pacific aims to maintain a capital structure that is appropriate for long term credit ratings of A3 to A1 on Moody's scale, A- to A+ on Standard & Poor's scale, and A- to A+ on Fitch's scale. Actual credit ratings may depart from these levels from time to time due to economic circumstances. As at 31st December 2006 the Company's long term credit ratings were A3 from Moody's, A- from Standard & Poor's, and A- from Fitch.

Key Credit Ratios

The table below sets out those credit ratios of the group which credit agencies commonly assess when determining credit ratings:

	2002	2003	2004	2005	**2006**
Operating margin					
– per accounts	32.5%	30.1%	117.6%	107.7%	**126.2%**
– underlying			31.2%	42.3%	**38.6%**
EBIT/net interest					
– per accounts	6.5	7.9	21.2	34.2	**36.8**
– underlying			6.7	15.0	**13.1**
FFO+net finance charges/net interest					
– per accounts	6.3	7.4	6.7	16.0	**12.5**
– underlying			6.2	14.7	**12.5**
FFO/net debt					
– per accounts	34.7%	52.1%	76.5%	177.9%	**69.5%**
– underlying			70.4%	162.3%	**69.5%**
Net debt/net capital					
– per accounts	16.1%	12.2%	8.9%	5.1%	**9.4%**
– underlying			8.1%	4.6%	**8.5%**
Rental income/net interest	4.2	4.3	2.8	5.2	**5.4**

Operating margin = Operating profit before depreciation and amortisation/turnover
EBIT = Earnings before interest and taxes
FFO (Funds from operations) = Operating profit less net finance charges less change in fair value of investment properties less tax paid plus depreciation plus profit or loss on sale of property, plant and equipment plus dividend from jointly controlled companies and associated companies plus non-cash items
Net capital = Equity attributable to the Company's shareholders plus minority interests plus net debt
Net interest is stated before deducting capitalised interest.
Underlying credit ratios are calculated by excluding the impact of adopting HKAS 40 and HKAS-Int 21 on investment properties and income taxes.

Cash Flow Summary

	2006 HK$M	2005 HK$M
Net cash generated by businesses and investments		
Cash generated from operations	**5,748**	5,158
Payment of land premium	**–**	(1,531)
Cash from asset realisations*	**1,840**	4,165
Dividends received	**2,448**	2,152
Capital expenditure and investments**	**(11,828)**	(2,466)
Tax and net interest paid	**(1,372)**	(785)
Net cash (outflow)/inflow before financing	**(3,164)**	6,693
Cash paid to shareholders and net funding by external debt		
Dividends paid	**(3,307)**	(3,686)
Increase/(decrease) in borrowings	**6,650**	(2,297)
Repayment of capital contribution to minority interest	**(2)**	(314)
Security deposits placed	**(381)**	–
Net cash used in financing activities	**2,960**	(6,297)
(Decrease)/Increase in cash and cash equivalents	**(204)**	396

* Includes proceeds from disposals of property, plant and equipment, investment properties, and sale of shareholdings in a subsidiary company, sale of shareholdings in and repayments of loans by associated and jointly controlled companies and available-for-sale investments.
** Includes additions to property, plant and equipment, investment properties, leasehold land and land use rights, intangible assets, available-for-sale investments, purchase of shareholdings in and loans to subsidiary, associated and jointly controlled companies.

Cash generated from operations includes HK$530 million from unit closings of trading property in The Carbonell residential development in Miami.

Cash from asset realisations was primarily derived from the sale of Hong Kong investment properties, sales of shares under the Cathay Pacific and Dragonair shareholding realignment, and the sale of a 10% interest in CITIC Square Shanghai.

Principal capital expenditure and investments include the acquisition of the remaining 50% interest in Festival Walk, the acquisition of a 49% interest in Swire Coca-Cola Beverages Xiamen, the acquisition of Alias a UK based boutique hotel group, the purchase of a 50% interest in the Dazhongli development in Shanghai for HK$1,329 million, and the purchase of nine additional offshore support vessels.

Changes in Financing

The major debt issues during the year included a seven year HK$1,800 million medium term note, a ten year US$600 million medium term note, a five year HK$3,500 million syndicated loan, and three year bilateral revolving credit facilities totaling HK$1,200 million. An additional HK$1,000 million in three year bilateral revolving credit facilities were signed after the year-end.

The major debt repayments during the year included HK$1,500 million in bilateral revolving credit facilities maturing in the period, the repayment of a five year HK$500 million medium term note, and the redemption of the US$300 million 9.33% perpetual capital securities on their first call date in October.

Surplus Funds

The group has surplus funds of HK$2,251 million which consists of short-term deposits and bank balances and certain available-for-sale investments as at 31st December 2006, compared to HK$2,000 million as at 31st December 2005.

Currency Profile

An analysis of net debt by currency at 31st December 2006 is shown below:

Currency	Total HK$M	%
Hong Kong Dollar	**10,878**	91
United States Dollar	**1,158**	10
New Taiwan Dollar	**71**	1
Others	**(177)**	-2
Total	**11,930**	100

Sources of Finance

At 31st December 2006, committed loan facilities and debt securities net of other borrowing costs amounted to HK$18,573 million, of which HK$4,838 million (26%) remained undrawn. In addition, the group has undrawn uncommitted facilities totalling HK$3,495 million. Sources of funds at the end of 2006 comprised:

	Available HK$M	Drawn HK$M	Undrawn HK$M
Committed facilities			
Perpetual Capital Securities	2,330	2,330	–
Fixed/Floating Rate Notes	7,931	7,931	–
Bank and other loans	8,312	3,474	4,838
Total committed facilities	18,573	13,735	4,838
Uncommitted facilities	3,940	445	3,495

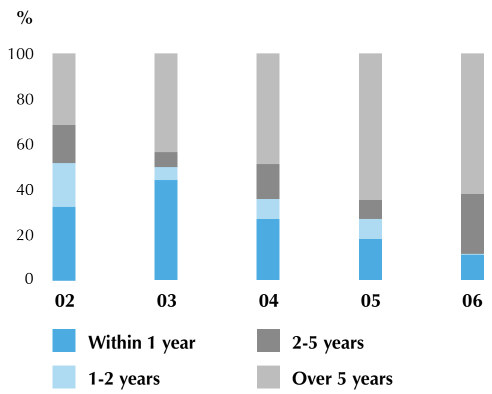
Maturity Profile and Refinancing

The group's weighted average term and cost of debt is:

	2006	2005
Weighted average term of debt	**5.8 years**	5.6 years
Weighted average term of debt (excluding Perpetuals)	**5.1 years**	2.0 years
Weighted average cost of debt	**6.7 %**	7.1%
Weighted average cost of debt (excluding Perpetuals)	**5.4 %**	3.6%

The maturity profile of the group's gross borrowings net of other borrowing costs and security deposits at the end of each of the last five years is set out below:

Maturity profile



Included in the group's debt is HK$2,330 million of Perpetual Capital Securities which the group can call at any time after 13th May 2017. As the call is at the option of the group, this debt is reported as having a life of the longer of the first call date and ten years.

The group manages refinancing risks by spreading the maturity of its facilities over a number of years so that refinancing needs are not excessive in any one year. The repayment schedule of the group's committed debt facilities is detailed below:

Debt Maturity

	2007 HK$M	2008 HK$M	2009 HK$M	2010 HK$M	beyond 2010 HK$M
Capital market debts	692	–	599	–	8,970
Bank loans	889	2,297	1,636	–	3,490
	1,581	2,297	2,235	–	12,460

Covenants and Credit Triggers

There are no specific covenants given by the group for its debt facilities which would require debt repayment or termination of a facility should the group's credit rating be revised by the credit rating agencies.

Swire Pacific has entered into financial covenants in respect of gearing limits and maintenance of minimum consolidated net worth, to secure funding for itself and its subsidiaries. These covenants are as set out below:

	Covenant limits	**2006**	2005
Gearing:			
Consolidated borrowed money/ adjusted consolidated net worth	≤ 200%	**10.4%**	5.4%
Secured consolidated borrowed money/ adjusted consolidated net worth	≤ 100%	**0.4%**	–
	HK$M	**HK$M**	HK$M
Maintenance of minimum consolidated tangible net worth:			
Consolidated tangible net worth	≥ 20,000	**115,091**	100,772

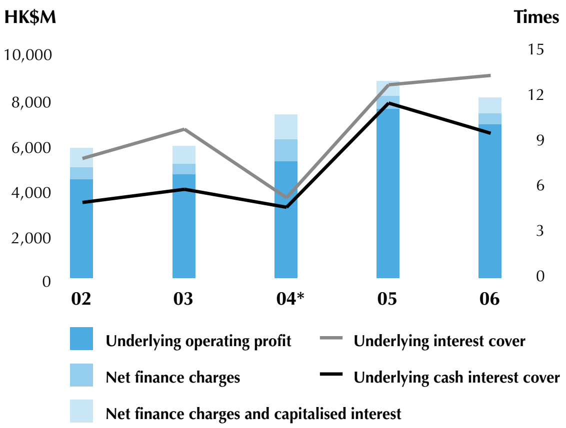
During the term of these facilities, none of the covenants were breached.

Interest Cover and Gearing

At 31st December 2006, 71% of the group's gross borrowings were on a fixed rate basis and 29% were on a floating rate basis.

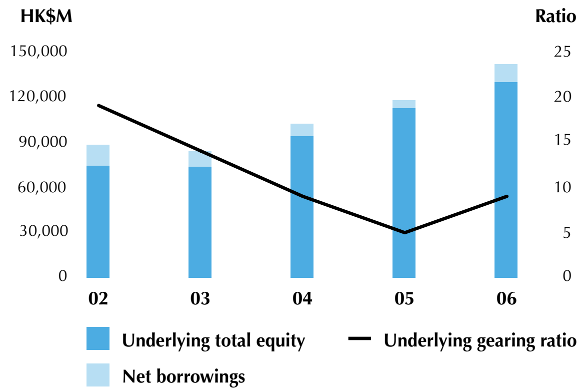
The following graphs illustrate the underlying interest cover and the underlying gearing ratios for each of the last five years.

Interest cover and cash interest cover



* This includes a one-off interest charge of HK$500 million in respect of the Taikoo Shing land premium dispute.

Gearing ratio



	Note	2006	2005
Gearing ratio	1		
Per accounts		**10%**	5%
Underlying		**9%**	5%
Interest cover – times	2		
Per accounts		**46.65**	34.09
Underlying		**13.44**	12.82
Cash interest cover – times	3		
Per accounts		**33.35**	30.86
Underlying		**9.61**	11.61

Notes:
1. Gearing represents the ratio of net borrowings to total equity (including minority interests).
2. Interest cover is calculated by dividing operating profit by net finance charges.
3. Cash interest cover is calculated by dividing operating profit by net finance charges and capitalised interest.
4. The calculation of underlying profit and underlying total equity is shown in the Financial Review section on page 38.

Attributable Profit Correlation

Swire Pacific's attributable profits comprise earnings from a diverse range of businesses. An examination of the degree of correlation between these earnings streams over the last ten years has been carried out and the results and preliminary implications are set out below. The correlation table below illustrates that the attributable net profits received from different business streams are either highly uncorrelated or negatively correlated. This underpins the relative stability of the earnings stream for the group as a whole.

	Core Property HK$M	Aviation HK$M	Beverages & Trading HK$M	Marine Services HK$M	Other business combined excluding core property HK$M
Underlying attributable profit of each division	3,074	2,271	924	834	4,029
Correlation coefficient:					
Core property	1.000	-0.104	0.193	-0.124	-0.054
Aviation	-0.104	1.000	0.505	0.362	0.957
Beverages & Trading	0.193	0.505	1.000	0.862	0.728
Marine Services	-0.124	0.362	0.862	1.000	0.598
Other business combined excluding core property	-0.054	0.957	0.728	0.598	1.000

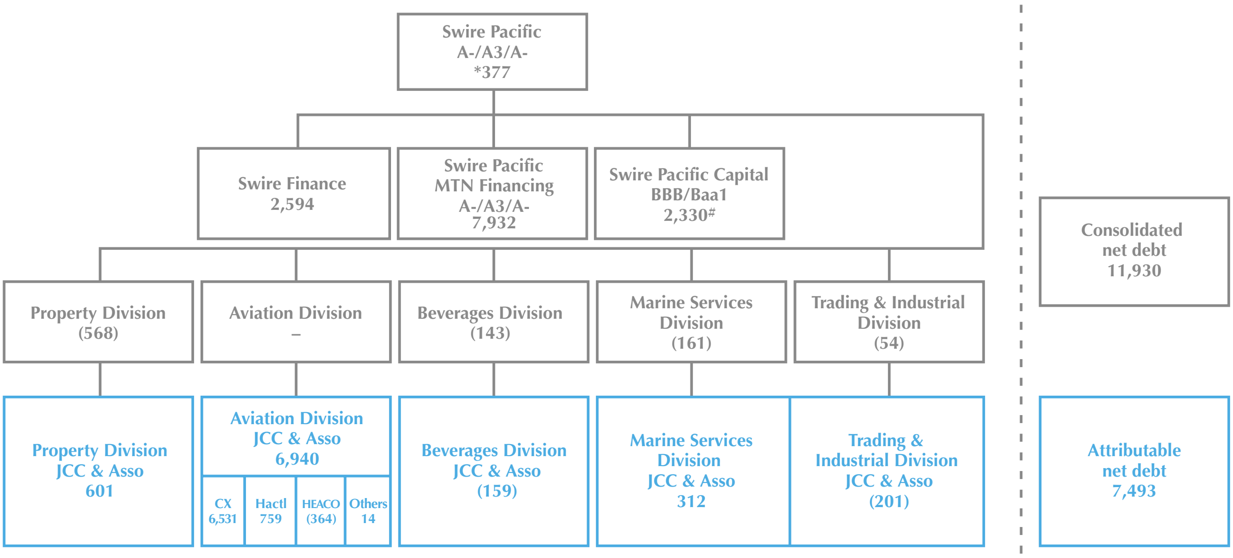
Note:
The underlying attributable profit has been adjusted to remove the impact of disposals.

Correlation key:
1 Highly correlated
0 Uncorrelated
-1 Highly negatively correlated

Swire Pacific group – Total Financial Obligations

The chart below illustrates net debt by borrowing entity, attributable net debt in jointly controlled and associated companies ("JCC & Asso") and undertakings given to third parties.

(In HK$M except specified)



* Undertakings given to third parties
# Represents US$300 million perpetual capital securities

Debt in Jointly Controlled and Associated Companies

In accordance with Hong Kong Financial Reporting Standards, the Swire Pacific consolidated balance sheet does not include the net debt of its jointly controlled and associated companies. These companies had the following net debt positions at the end of 2006 and 2005. If the attributable portion of the net debt in jointly controlled and associated companies were to be added to the group's net debt, gearing would rise to 17% and underlying gearing would rise to 15%.

	Total net debt		Portion of net debt attributable to the group		Debt guaranteed by Swire Pacific or its subsidiaries	
	2006	2005	**2006**	2005	**2006**	2005
	HK$M	HK$M	**HK$M**	HK$M	**HK$M**	HK$M
Property Division	**1,884**	1,763	**601**	585	**304**	315
Aviation Division						
Cathay Pacific	**16,348**	9,050	**6,531**	4,193	**–**	–
Hactl	**3,796**	3,578	**759**	881	**–**	–
Dragonair	**–**	2,352	**–**	417	**–**	–
HAECO	**(834)**	(877)	**(364)**	(396)	**–**	–
Other Aviation Division companies	**30**	623	**14**	100	**6**	6
Beverages Division	**(317)**	(538)	**(159)**	(274)	**–**	–
Marine Services Division	**610**	707	**312**	405	**500**	500
Trading & Industrial Division	**(345)**	(301)	**(201)**	(149)	**–**	–
	21,172	16,357	**7,493**	5,762	**810**	821

Financial Assistance to Affiliated Companies and their Proforma Combined Balance Sheet

Pursuant to Chapter 13 of the Listing Rules, a proforma combined balance sheet of those affiliated companies with financial assistance from the group and the group's attributable interest in those affiliated companies are presented below.

Affiliated companies comprise the group's jointly controlled and associated companies. As at 31st December 2006, the group had loans to affiliated companies totalling HK$10,714 million (before group provisions) and has given guarantees of HK$1,280 million in respect of facilities granted to affiliated companies, financial assistance totalling HK$11,994 million. These amounts exceed 8% of the group's total assets as at 31st December 2006.

	31st December 2006	
	Proforma combined balance sheet	The group's attributable interest
	HK$M	HK$M
Non-current assets	28,420	11,089
Current assets	4,022	1,434
Current liabilities	(3,762)	(1,371)
Non-current liabilities	(3,051)	(976)
Minority interests	(367)	(180)
Shareholders' advances	(27,546)	(10,714)
	(2,284)	(718)