MANAGEMENT DISCUSSION AND ANALYSIS

(Expressed in Hong Kong dollars)

Overall Performance

The Group's profit attributable to shareholders increased by 69 per cent to $879 million (1999: $521 million). The increase was mainly due to a 27 per cent growth in total income while costs edged up moderately by 6 per cent.

Income

Total income increased by 27 per cent to $2,312 million (1999: $1,815 million). The rise in income was attributable mainly to a more buoyant cash market in 2000. Average daily turnover of the cash market registered a growth of 63 per cent mainly on account of the bullish sentiment in early 2000, the robust US stock markets and the resumption of economic growth in Hong Kong. The increase was partially offset by lower income from futures market activities as the uncertainties caused by the migration of the HSI futures and options trading from the trading floor to the Automated Trading System (HKATS) brought about a 14 per cent reduction in the average daily number of contracts traded on the Hong Kong Futures Exchange Limited (the Futures Exchange).

Due to the robust cash market, total transaction levy, trading tariff and trading fees increased by 28 per cent to $548 million (1999: $428 million) despite a reduction in the Group's entitlement to the transaction levy from cash market trading from 0.007 per cent to 0.005 per cent since June 2000, and reduced trading in futures contracts.

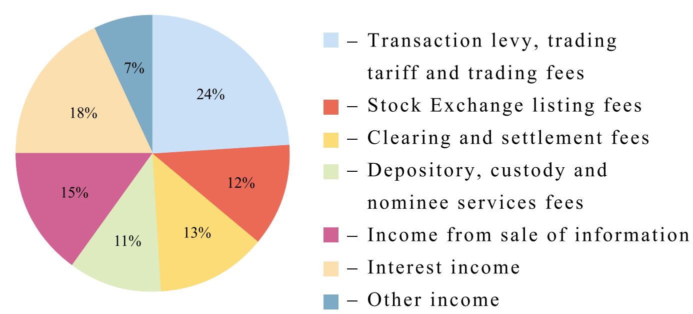
Listing fee income rose by 31 per cent to $270 million (1999: $206 million) attributable primarily to more new listings on the back of a flourishing capital formation market and higher number of listed securities. As at 31 December 2000, there were 736 companies listed on the main board and 54 on the Growth Enterprise Market (1999: 701 and 7).

As a result of the surge in cash market activities, clearing and settlement fee income recorded a growth of 56 per cent to $305 million (1999: $196 million); depository, custody and nominee services fee income surged by 79 per cent to $257 million (1999: $144 million) as corporate actions increased and more shares were deposited with the Central Clearing and Settlement System (CCASS) depository; and income from sale of information rose by 54 per cent to $352 million (1999: $229 million) as the demand for stock information increased.

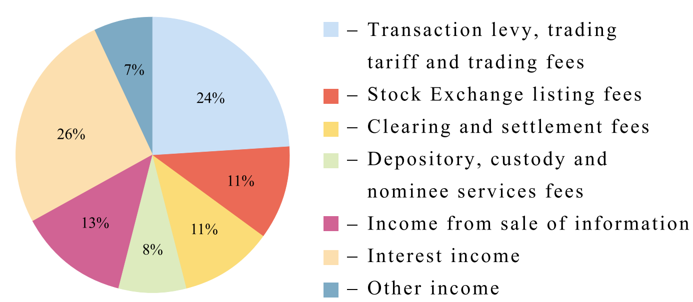
Interest income fell by 13 per cent to $414 million (1999: $474 million) brought about mainly by lower interest income from margin funds as the average size of margin funds received fell by 11 per cent in 2000 on account of reduced trading in futures contracts.

Other income increased by 19 per cent to $165 million (1999: $139 million) due mainly to a surge in share registration service fee income on the strength of the increased number of initial public offerings.

Analysis of income 2000



Analysis of income 1999



Operating Expenses

Total operating expenses increased by 6 per cent to $1,327 million (1999: $1,258 million).

Staff costs and related expenses rose by 4 per cent to $593 million (1999: $571 million). In line with prevailing market practice and in recognition of better performance, the Group awarded an average salary increase of 7 per cent in July and a higher performance-related bonus in 2000 to its staff. The increase was partially offset by savings from staff reductions (staff numbers fell by 17 per cent during 2000 to 891) following the integration of the Group's activities.

Due to further improvements to our trading and settlement systems, information technology and computer maintenance expenses increased by 10 per cent from $198 million to $217 million mainly on account of the development of Automatic Order Matching and Execution System (AMS)/3, the migration of futures trading to HKATS and CCASS architecture review.

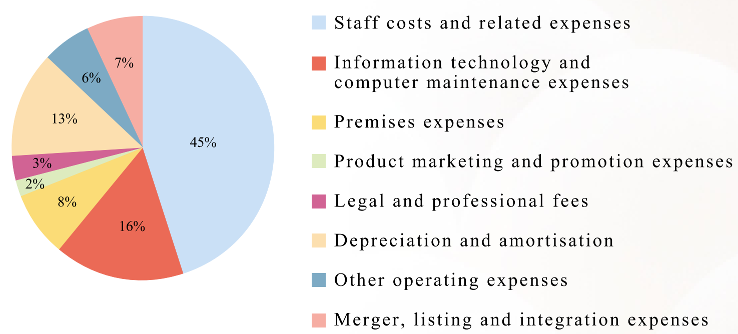
Premises expenses fell by 5 per cent to $109 million (1999: $115 million) due mainly to lower rental negotiated when the commercial property market remained depressed.

Depreciation and amortisation rose by 18 per cent to $177 million (1999: $150 million). The increase was attributable mainly to additional depreciation upon the roll-out of AMS/3 and HKATS and the standardisation of Group policy on depreciation, which came into effect in 2000.

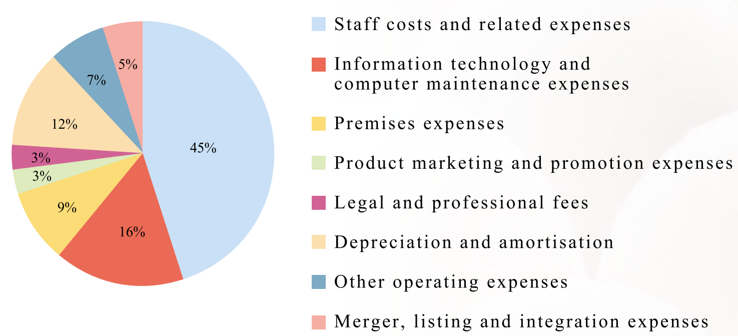
Other operating expenses declined by 18 per cent to $74 million (1999: $90 million) as a special contribution of $13 million to the Unified Exchange Compensation Fund (Compensation Fund) in 1999 was not repeated in 2000.

Merger, listing and integration expenses, all of which were non-recurring, increased by 55 per cent to $93 million (1999: $60 million) attributable mainly to expenses incurred for the listing of the Group in June 2000, consultancy fees on the integration of the Group's operations, and redundancy costs.

Analysis of operating expenses 2000



Analysis of operating expenses 1999



Taxation

The Group's taxation charge in 2000 increased by 190 per cent to $106 million (1999: $36 million). This was primarily due to the higher profit reported in 2000 and a one-off tax rebate on 1997/98 profit ($13 million) received in 1999. The Group's effective rate of taxation, at 10.7 per cent, was lower than the statutory Profits Tax rate of 16 per cent. This was mainly on account of the effective management of the Group's tax affairs and interest income earned, which has been exempted from Profits Tax.

Liquidity, Financial Resources and Capital Commitments

Working capital increased by 19 per cent to $3,045 million at 31 December 2000 (1999: $2,557 million) attributable mainly to the increase in retained earnings. Bank balances and time deposits of corporate funds rose by 10 per cent to $3,635 million (1999: $3,300 million).

Although the Group has consistently been in a very liquid position, credit facilities have nevertheless been put in place for contingency purposes. As at 31 December 2000, the Group's total available credit facilities amounted to $2,895 million, of which $1,600 million were repurchase facilities for maintaining the liquidity of the margin funds and $1,100 million were for meeting obligations of Hong Kong Securities Clearing Company Limited (HKSCC) in 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 the year end, none of these facilities was utilised (1999: short-term bank borrowings under a repurchase agreement with a bank amounted to $204 million and the assets pledged amounted to $206 million).

As at 31 December 2000, the Group's capital expenditure commitments amounted to $381 million (1999: $242 million) mainly in respect of its ongoing investments in facilities and technology. The Group has adequate financial resources to fund its commitments on capital expenditure from its existing cash resources and cash flows generated from its operations.

Charges on Assets

The Group had a $10 million overdraft facility with a bank in Hong Kong, which was secured by a pledge of the Group's time deposits of an equivalent amount at that bank. As at 31 December 2000 and 31 December 1999, this overdraft facility was not utilised.

In 1999, $1 billion of banking facilities granted by ten banks on a committed basis to HKSCC were secured by a debenture creating a floating charge over its assets. Such banking facilities were to provide stand-by liquidity to meet the obligations of HKSCC in CCASS in circumstances where CCASS Participants default on their payment obligations. These banking facilities were not utilised as at 31 December 1999 and were terminated on 12 December 2000 and replaced by the banking facilities mentioned under Contingent Liabilities below.

Significant Investments Held and Material Acquisitions and Disposals of Subsidiaries

Other than the acquisition and merger of the exchanges and clearing houses into HKEx on 6 March 2000, the Group also acquired a 1 per cent holding (10 million shares) in the issued ordinary share capital of the Singapore Exchange Limited during the year. No subsidiary was disposed of in 2000.

Exposure to Fluctuations in Exchange Rates and Related Hedges

The Group's foreign exchange exposure was about $180 million as at 31 December 2000, of which $125 million was hedged with investments in the same currency.

Contingent Liabilities

The Compensation Fund is a fund set up under the 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 defaults 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 the SO section 107(1), The Stock Exchange of Hong Kong Limited (the Stock Exchange) has contingent liabilities to the Compensation Fund as it shall replenish the Compensation Fund upon the Securities and Futures Commission's (SFC) request to do so. The amounts 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. As at 31 December 2000, there were outstanding claims received in respect of 18 defaulted Stock Exchange Participants (1999: 9).

The SFC has recently published a paper entitled "Proposed New Investor Compensation Arrangements". If the proposals as set out in the paper are implemented, there would be a new single Investor Compensation Fund that would replace the existing Compensation Fund, the Commodity Exchange Compensation Fund and the Dealers' Deposit Schemes for non-exchange participant dealers. The new arrangements would eliminate the existing requirements for exchange participant dealers to make deposits to the Dealers' Deposit Schemes. Existing deposits would be returned to the Exchanges and to non-exchange participant dealers. The arrangements would also remove the existing requirement for the Stock Exchange to replenish amounts paid from the Compensation Fund.

In addition to the above, the Group has a contingent liability of up to $50 million to the Compensation Fund. The Group agreed to commit an additional $150 million to the Compensation Fund of which a total of $100 million was paid out of the CDMD Fund in 1998 and 1999. The remaining $50 million of the commitment will be satisfied by a transfer of funds that will be available on the winding up of the Hong Kong Futures Guarantee Corporation Limited. Should the funds expected to be received from the Hong Kong Futures Guarantee Corporation Limited not be sufficient to satisfy the payment of the said $50 million, the Group would have to pay for the shortfall 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 defaults of any one Participant. In the unlikely event that all of the 500 trading Participants as at 31 December 2000 (1999: 491) default, the maximum contingent liability of the Stock Exchange under the indemnity will amount to $100 million (1999: $98.2 million).

Pursuant to Section 21 of the Exchanges and Clearing Houses (Merger) Ordinance, 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.

HKEx has given a guarantee to secure banking facilities granted to HKSCC since 13 December 2000 to replace the $1 billion of banking facilities mentioned under Charges on Assets above. These facilities, on a committed basis of an aggregate amount of $1.1 billion, were granted to HKSCC by five banks to provide stand-by liquidity to meet HKSCC's obligations in CCASS in circumstances where the CCASS Participants default on their payment obligations. As at 31 December 2000, none of these banking facilities was utilised.

Employees

During the integration of the businesses of the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group within a new business organisation structure, HKEx has developed its human resources policies and procedures based on performance and merit. The Group expects to reduce the total number of employees from 1,052 to 860. The number of employees as at 31 December 2000 was 891, further reductions in number of employees to reach the target number will be achieved during the first half of 2001.

Employees' cost (excluding directors' emoluments) amounted to approximately $586 million (1999: $571 million).

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 be granted to Directors and employees of the Group to subscribe for shares in HKEx in accordance with the terms and conditions of the Share Option Schemes approved by the shareholders of HKEx at an extraordinary general meeting held on 31

May 2000. In June, options to subscribe for a total of 36,423,269 shares were granted under the Share Option Schemes.

Prospects

As a substantial part of the Group's income is derived from transaction levy, clearing and settlement fees and interest income on margin funds, the performance of the Group is dependent on external factors including, in particular, market sentiment, the level of activities on the Stock Exchange as measured by dollar value and on the Futures Exchange as measured in terms of the number of open contracts and the volatility of the derivatives market. Following the end of the bullish sentiment in the first two quarters, trading volume in the cash market returned to a more normal level in the latter half of 2000. If this trend was to continue, the income expected to be generated in 2001 might not reach the levels achieved in 2000.

However, the Group will strive to attract investors and capital raising companies by further enhancing the efficiency and transparency of its cash and derivatives markets with the latest applicable technology and improved accessibility to facilitate trading. In this connection, the Group will continue to upgrade and integrate its trading, clearing and risk management systems and respond to market needs by introducing new services and products. More efforts will also be made to further improve the risk management, integrity and quality of the markets. Following the establishment of an office in Beijing in the first half of 2001, more initiatives will be undertaken to further promote the Group as one of the primary international capital raising centres for Mainland companies. These measures should enable the Group to increase its earning potential.

With the process of integrating the businesses of the subsidiaries largely completed, the Group is in a position to deal more effectively with new developments in the markets.

HKEx invests extensively in technology in order to increase market efficiency.

T E C H N O L O G Y

- **HKEx's systems have more than 4,500,000 lines of source code and handle more than 320,000,000 messages and over 3,000,000 transactions daily, including order input and various enquiry transactions.**