Financial review

Financing achievements

During 2001, we succeeded in capitalising on our good standing in the financial market to reduce substantially our borrowing costs in a very challenging business environment. We completed a sizeable financing programme to fund our continued expansion, maintained a solid balance sheet and saw our high credit ratings reaffirmed.

HK$16 billion debt raised

The Group completed a borrowing programme totalling HK$16 billion during 2001. The funding was mainly used to refinance less cost-effective credit facilities and to cover our capital expenditure on railway projects .

Given the ample liquidity and very attractive pricing available domestically, we decided to focus in 2001 on the Hong Kong dollar market. We completed HK$11 billion of financing through bilateral and club loan facilities at very fine spreads and with maturities of up to seven years, taking advantage of the historically low pricing in the loan market.

The domestic bond market also offered attractive opportunities as interest rates fell substantially throughout the year. Institutional investors were eager to lock in fixed rate investments in sizeable amounts and to extend maturity. Tapping into this very significant demand, the Group issued a total of HK$5 billion of medium term notes at very attractive all-in costs.

Despite our focus in financings on the Hong Kong dollar market in 2001, our US dollar bonds continued to attract a strong following among international investors. Benefiting from this demand and excess liquidity in Asia, our Global and Yankee bonds performed extremely well in the secondary market. Our 2010 Global bonds traded as tight as 90 basis points above the yield of comparable US treasuries, down from around 160 basis points at the beginning of the year. As a result of this impressive performance and our sovereign credit ratings, the MTR 2010 Global bond has remained a key benchmark for new US dollar bond issues from Hong Kong.

As at the year-end the Group had a total of HK$5.5 billion in undrawn committed facilities, which are sufficient to cover our anticipated funding needs up to the first quarter of 2003.

Borrowing costs reduced

The finer borrowing terms and lower interest rates available during 2001 allowed the Group to cut its interest cost while maintaining a conservative mix of fixed and floating rate debt to reduce interest rate risk. The average borrowing cost for the year fell to 6.6% from 7.8% in 2000, resulting in a HK$269 million reduction in net interest expense. This made a significant contribution to our bottom line and further strengthened our debt servicing capability.

No new equity issued

At MTR's initial public offering in 2000, the Hong Kong SAR Government indicated that it would further reduce its equity holding in us in the fiscal year ending March 2002, while maintaining a majority holding for at least 20 years. Due to adverse market conditions, the Government has not yet announced a firm timetable for the second sale of MTR shares.

Although our undertaking not to issue further equity expired in the fourth quarter of 2001, we did not raise capital through new equity financings in view of our strong balance sheet, the very favourable interest rate environment and the Company's strong financing capacity in the debt market.

Sound risk management

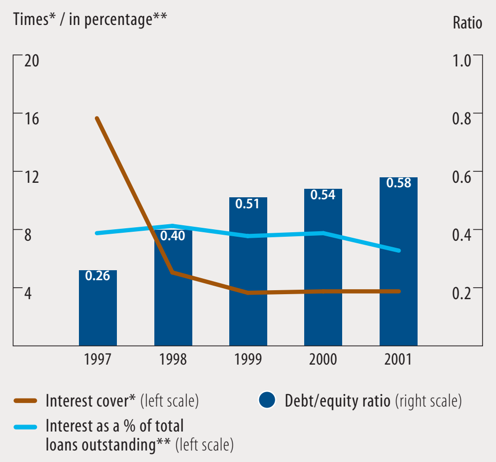
MTR's risk management strategy in relation to financing activities has achieved excellent results in recent years despite severe market volatility. During 2001, we continued to manage our debt portfolio in accordance with the well-established Preferred Financing Model. The Model seeks to diversify risks by specifying the preferred mix of fixed and floating rate debt, the permitted level of currency exposure, a well-balanced spread of maturities, the use of different types of financing instruments and an adequate length of financing horizon. By adhering to the Model, we have achieved a balanced debt profile with adequate risk diversification and forward coverage.

The risks associated with off-balance sheet transactions have been highlighted recently by events in the energy industry. MTR remains one of the most active corporate users of off-balance sheet financial derivative instruments in Hong Kong. However, such instruments are used solely for hedging purposes to reduce risk and not for speculation. We use derivatives to manage interest rate and currency exposures, in order to achieve a debt profile guided by the Preferred Financing Model. In addition, we generally deal only with counterparties enjoying credit ratings of single A or better and has developed a framework to monitor and control counterparty risk exposure using the "expected loss" concept and "value-at-risk" methodology.

Strong credit ratings

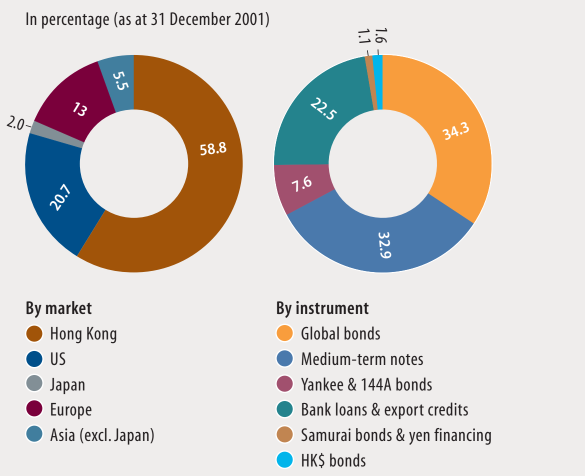
The volatile and difficult business environment in 2001 has affected the credit ratings of many large multinationals. In contrast, MTR's strong credit fundamentals have continued to receive high recognition from international rating agencies. We were the first Hong Kong corporate borrower to obtain international credit ratings and have since enjoyed the same ratings as the Hong Kong Government from Moody's, Standard & Poor's and R&I. Following the upgrade of Hong Kong's sovereign ratings early in the year, Standard & Poor's raised the Company's long-term

Debt servicing capability



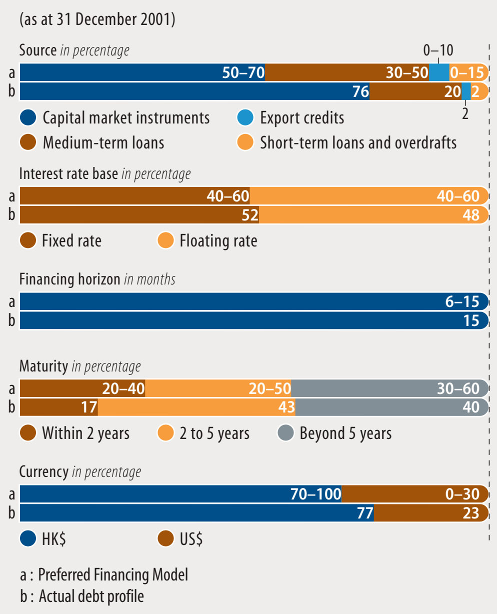
We carefully manage our debt/equity ratio and interest cover in establishing our financial plans.

Sources of borrowing



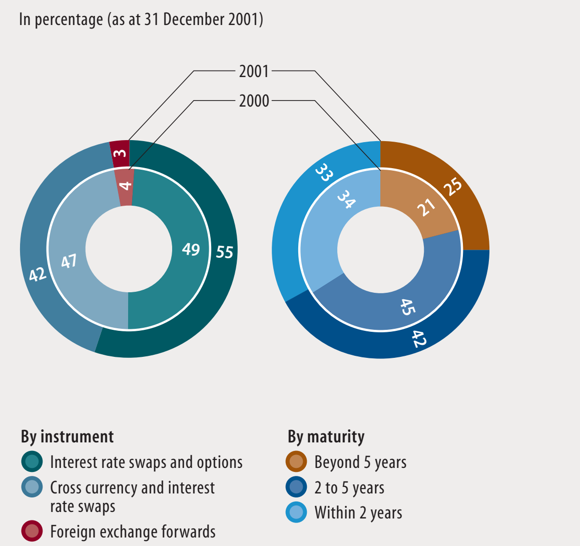
Ample liquidity and fine rates led MTR to raise substantial amounts in the Hong Kong dollar market in 2001.

Preferred Financing Model and debt profile



We maintained a well-diversified debt portfolio with adequate forward coverage of future funding consistent with the Company's Preferred Financing Model

Use of interest rate and currency risk hedging products



A variety of hedging instruments are used to manage our debt portfolio and foreign currency exposures. Derivatives are used only for hedging purposes and no speculative positions are taken.

domestic/foreign currency ratings from A+/A to AA-/A+ in February 2001 to be on par with the Hong Kong SAR Government. At the same time, the agency revised MTR's short-term domestic/foreign currency ratings from A-1/A-1 to A-1+/A-1 and maintained the outlook as stable.

Credit ratings

	Short-term ratings *	Long-term ratings *
Standard & Poor's	A-1+/A-1	AA-/A+
Moody's	–/P-1	Aa3/A3
Japan Rating and Investment Information Inc. (R&I)	a-1+/–	AA/AA-

* Ratings for Hong Kong dollar denominated debt and foreign currency denominated debt respectively.

Moody's re-affirmed in May 2001 our short-term foreign currency and long-term domestic/foreign currency ratings at respectively P-1 and Aa3/A3, the same as for the Hong Kong SAR Government. Earlier in February, it had revised the outlook of our A3 foreign currency rating from stable to positive following a similar change to the outlook of Hong Kong's foreign currency sovereign rating.

MTR's Japanese credit ratings at AA/AA- for long-term domestic/foreign currency debts and a-1+ for short-term local currency debt were also re-affirmed by R&I in May 2001.

Prudent financial planning

In light of the difficult operating environment during the year, we carefully reviewed all aspects of our business and where appropriate adjusted key planning assumptions to ensure our financial plan remain robust given the prevailing conditions and future expected returns.

Under the revised financial plan, we will continue our efforts to enhance revenue and improve cost efficiency so as to achieve continuous improvement in our operating results. With further cost reductions for the Tseung Kwan O Extension and continued streamlining of other capital works, our capital expenditure programme for the next three years between 2002 and 2004 inclusive has been reduced to HK$10.6 billion. This should leave us with significant financing capacity to undertake new projects in the next few years.

In July 2001 we submitted to the Government a tender bid for the Shatin to Central Link, as well as a project proposal for the Island Line Extensions. Our financing plans for these proposals were prepared on the basis that our current financial strength will be largely maintained. Since these tenders and proposals are currently being reviewed by the Government, we will examine the appropriate capital structures and funding alternatives in more detail at a later stage.

MTR has a well established and sophisticated long-term financial planning model based on a clear methodology for evaluating new projects and investments. All investment proposals are subject to a rigorous evaluation process taking into account our weighted average cost of capital. The key financial planning assumptions are carefully reviewed as part of our annual budgeting exercise and sensitivity analyses are conducted on key variables. Our capital structure as well as key financial ratios including interest, dividend and cashflow coverages, are carefully monitored on a regular basis.

We will continue with our railway development strategy whereby property developments are undertaken at sites along new railways to supplement returns on railway investment. These property development earnings also help mitigate the effect of increased depreciation and interest charges during the early years of the railway operations.

Review of financial results

Profit and loss

Total patronage for the MTR Lines, which comprise the Urban Lines and the Tung Chung Line, declined by 1.2% from 767 million in 2000 to 758 million in 2001. The average weekday patronage stood at 2.23 million, compared to 2.24 million in 2000. Our overall market share declined from 24.1% in 2000 to 23.5% and our cross-harbour market share slipped from 57.9% to 57.4%.

Total fare revenue for the MTR Lines amounted to HK$5,164 million, which was marginally below the figure of HK$5,166 million in 2000. The average fare increased from HK$6.73 in 2000 to HK$6.81, mainly as a result of the full year effect of the additional 10 cents per ride charged since July 2000 in relation to the platform screen doors project and increased length of average journey.

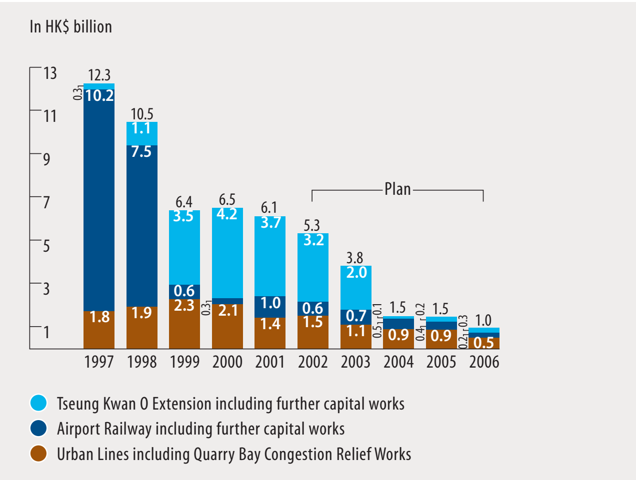
The average daily patronage on the Airport Express Line declined by 11.7% to 25,000 from 28,300 in 2000, following the removal of the remaining 10% fare discount from July 2001 and the decline in air travellers in the last quarter of the year. Our estimated market share of passengers travelling to and from the airport fell from 28% in 2000 to 27%. Despite the reduction in patronage, total revenue from the Airport Express Line grew by 2.7% to HK$564 million, with the average fare increasing from HK$53.1 to HK$62.5 in 2001.

Non-fare revenues increased marginally from HK$1,862 million in 2000 to HK$1,864 million, comprising HK$891 million from property rental and management and HK$973 million from station commercial and other revenue. Because of the sluggish economy, advertising business recorded a 15.1% reduction in revenue to HK$428 million in 2001. However, this was partly compensated by an increase in property management income and external consultancy revenues.

Operating expenses before depreciation decreased by 3.5% from HK$3,663 million in 2000 to HK$3,533 million. A reduction in staff costs was again achieved in 2001, from HK$1,688 million in 2000 to HK$1,641 million, reflecting cost savings from the continuous improvement in productivity and efficiency and the effective redeployment of staff in the past two years. Other operating costs decreased by 4.2% as a result of better pricing obtained on maintenance and service contracts and a reduction in revenue and maintenance projects.

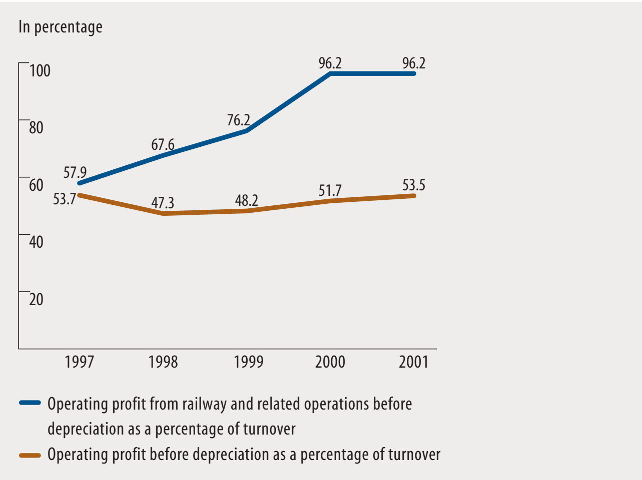
The operating profit from railway and related operations before depreciation amounted to HK$4,059 million, an increase of 3.7%

Investment in new railway lines and the existing network



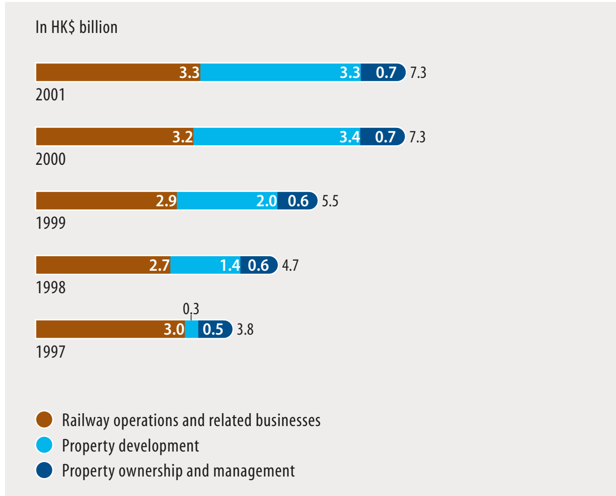
The Tseung Kwan O Extension is currently our main investment project. Careful management and lower prices have reduced the estimated outturn cost by over 40% or HK$12.5 billion.

Operating margin



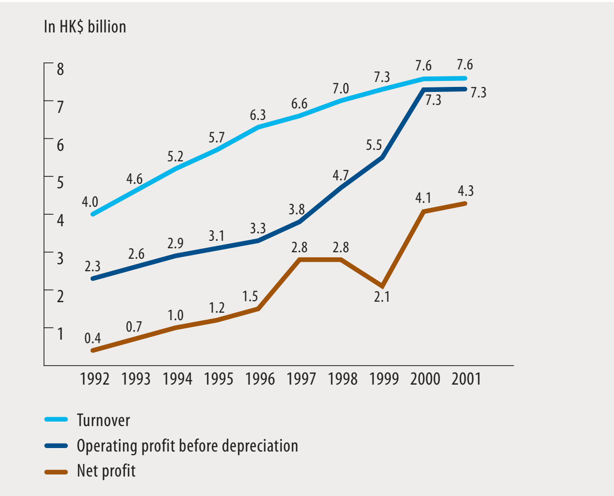
In 2001 we achieved an operating margin of 53.5% from railway and related operations, the highest since 1998.

Operating profit contributions



Revenues from the railway operations and related businesses increased their contribution to profitability in 2001.

Net results



Given the poor economic conditions, our stable revenues and 5.3% increase in net profits were creditable achievements.

from HK$3,914 million in 2000. This represented a margin of 53.5% on total revenue and was the highest since 1998.

Profit on property developments amounted to HK$3,248 million as compared with HK$3,376 million for the previous year, including mainly the profit recognition of deferred income and sharing of profits in respect of certain Airport Railway developments in line with their construction progress and the pre-sale of properties. The amounts recognised during the year related mainly to Tung Chung, Kowloon and Olympic station developments.

Operating profit before depreciation increased marginally by 0.2% to HK$7,307 million. Depreciation and amortisation charges increased by 4.2% to HK$2,178 million following capitalisation of the Quarry Bay Congestion Relief Works project costs during the year. As a result, operating profit after depreciation decreased by 1.3% from HK$5,199 million in 2000 to HK$5,129 million.

Net interest expense fell from HK$1,143 million in 2000 to HK$874 million, reflecting the lower average interest rate paid on our borrowings, at 6.6% compared to 7.8% for 2000.

Net profit for the year increased by 5.3% from HK$4,069 million in 2000 to HK$4,284 million. Both basic and diluted earnings per share were HK$0.85.

The Board has recommended a final dividend of 28 cents per share, amounting in total to HK$1,415 million, with a scrip dividend option offered to all shareholders. The Government has agreed to receive its entitlement to dividends in the form of shares to the extent necessary to ensure that a maximum of 50% of MTR's total dividend will be paid in cash.

Balance sheet

The Group's balance sheet continued to be well capitalised, with the bulk of our assets invested in the railway system. Total fixed assets increased from HK$78,475 million last year to HK$79,243 million as at 31 December 2001. The increase was mainly attributable to capital expenditure on railway improvement works, including rolling stock modernisation, station improvements, Quarry Bay Congestion Relief and West Rail Interface works, as well as major upgrading and improvements to investment properties.

Construction of the Tseung Kwan O Extension project has progressed according to programme. The total cost incurred during the year amounted to HK$3,665 million, bringing the total expenditure for the project to HK$12,833 million by the year-end. As a result of the continued cost reduction measures, the latest estimate of total project cost has been further reduced from HK$21 billion to HK$18 billion, representing saving of over 40% from the original budget of HK$30.5 billion.

Property development in progress represents the costs incurred in preparation of sites for property developments less reimbursements already received from developers. Property development in progress at the year-end amounted to HK$3,361 million, an increase of 24.5% from last year's HK$2,699 million. This is mainly due to further costs of foundation works incurred for developments along Tseung Kwan O Extension, where the amounts will be recoverable from developers in due course.

Total loans outstanding at the end of the year amounted to HK$31,385 million, an increase of HK$4,182 million from last year. Loan drawdowns from existing and new facilities during the year were mainly used to finance the construction of the Tseung Kwan O Extension project and capital works for the MTR system. As a result, our debt-to-equity ratio increased from 54.0% a year ago to 58.1% at year-end 2001, in line with our longer-term financial plan. Our interest cover remained at a satisfactory level of 3.8 times, the same as last year.

Deferred income decreased from HK$10,403 million in 2000 to HK$8,411 million, as amounts were recognised as profit in accordance with the progress of construction and pre-sales of property development projects at Kowloon, Olympic and Tung Chung stations. The deferred income as at 31 December 2001 comprised mainly balances in respect of packages at Tung Chung and Kowloon stations.

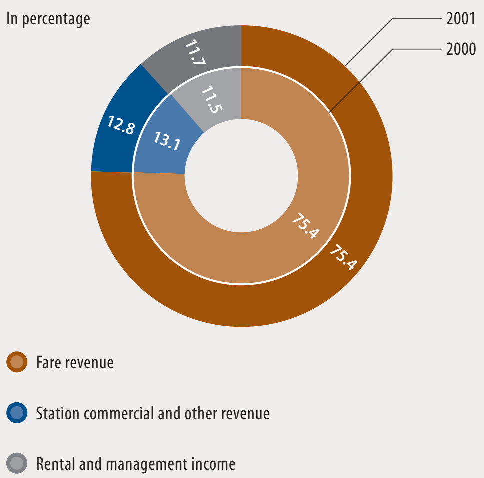
Our share capital of HK$32,807 million was slightly higher than in 2000, as a result of shares issued from the scrip dividend and share options exercised.

As at 31 December 2001, total shareholders' funds stood at HK$54,049 million, an increase of HK$3,694 million from HK$50,355 million as at 31 December 2000. The increase was mainly attributable to the retained profit of HK$3,081 million and the shares issued from scrip dividends of HK$601 million.

Cash flow

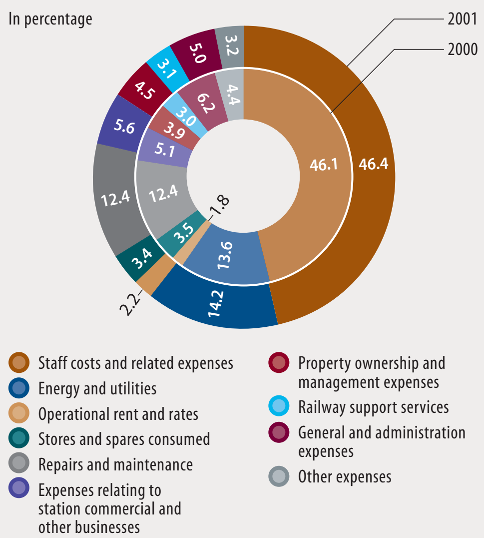
The net cash inflow from operating activities increased slightly to HK$4,155 million from HK$3,756 million last year due to higher revenues and lower operating expenses. The main cash outflow related to the Tseung Kwan O Extension and other capital work projects, which together with interest and dividends paid amounted to HK$8,312 million. The net loan drawdown for the year increased slightly from last year's HK$4,125 million to HK$4,310 million.

Turnover



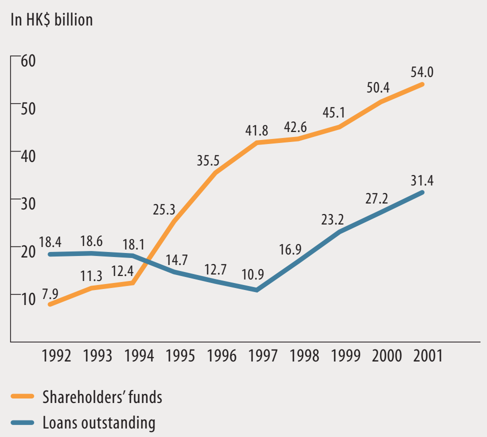
In 2001, fare revenues as a percentage of total revenues were flat, while an increase in property rental and management income offset a decline in other income.

Operating expenses



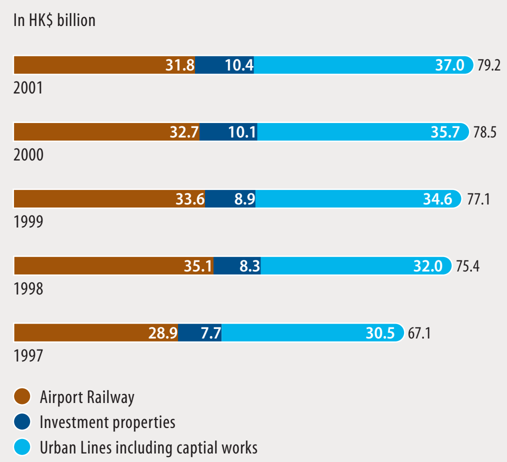
MTR continued to make progress in reducing operating costs which decreased 3.5 % to HK$3,533 million.

Debt/equity profile



As a result of the need to fund the Tseung Kwan O Extension and other capital works, our debt/equity ratio rose to 58.1% at year end, in line with our long term financing plan and still at a prudent level.

Fixed assets growth



Total fixed assets grew as MTR refurbished investment properties and conducted railway improvement works.