

Management Discussion⁺ and Analysis



REVIEW OF OPERATIONS

Overview

2003 was another landmark year for SUNDAY. The Group recorded its first annual profit of HK\$27 million in a difficult year. EBITDA and cash inflow from operating activities increased by 47% and 87%, respectively, to HK\$315 million and HK\$242 million in 2003. The subscriber base increased by 9% to 660,000. Owing to the outbreak of SARS and price based competition during 2003, however, the Group's average revenue per user ("ARPU") declined by 4% to HK\$201.

The significant improvement in the Group's financial results in 2003, despite difficult market conditions and a weak economy, clearly shows the benefits of the various initiatives to improve efficiency implemented in 2002 and 2003. SUNDAY's ability to operate with a leaner and more efficient structure well ahead of the industry has proven an important competitive advantage. During 2003, SUNDAY continued to improve network and pre- and post-sales service quality and to introduce many new innovative services to customers.

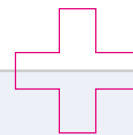
In 2003, the Group also signed Heads of Agreements with Huawei Technologies Co., Ltd. ("Huawei"), under which Huawei will provide a turnkey solution for the roll-out of SUNDAY's 3G network and services. The contract is supported by financing. As a result, the Group will be able to launch 3G services in the final quarter of 2004, but also has the flexibility to reschedule the launch date if market acceptance is different from that expected.

Mobile services

The year 2003 was full of challenges. The industry was adversely affected by the outbreak of SARS and the weak economy in general. Some competitors launched aggressive price promotions to secure short-term gains. To respond to these challenges, SUNDAY invested in the quality of its service delivery and continued its creative approach focused on market segmentation and service innovation. This strategy coincides with a shift in consumer attitudes as customers begin, increasingly, to value innovation and service quality.

The Group also continued to enhance its network coverage and quality. Over the past three years, the number of cell sites has increased by about 25%. To enhance sales and marketing, teams were reorganised under new management that combines traditional mobile telecommunications expertise with an understanding of fast-moving consumer markets. Customer care benefited from new management systems that enable SUNDAY to better track how effectively customer service needs are being met and build this data into performance measurements for individual business units. There was also increased use of quality assurance techniques to improve and monitor service delivery.

During 2003, the Group reorganised its operations according to distinct customer segments, namely, youth, ethnic, corporate and the mass market. Each is run as a sub-business, responsible for products, pricing, promotion and distribution channels, with separate targets for subscribers, ARPU, churn and other metrics.



The Group continued to make customer retention a priority and maintain tight control over churn and the average monthly gross churn rate, calculated as a percentage of opening subscribers, improved to 5.0% in 2003 as compared with 5.4% in 2002. The relatively high churn rate was mainly attributable to adverse market conditions in the first three quarters in 2003, but the rate has significantly decreased since the fourth quarter of 2003. The churn rate in December 2003 was 3.6%.

Despite the difficult market conditions, high service quality and SUNDAY's segmentation strategy enabled the Group to grow its mobile subscriber base, which increased by 9% to 660,000. The revenue from the mobile services business for 2003 declined moderately by 6% to HK\$1,150 million from HK\$1,218 million in 2002 as ARPU for 2003 fell a modest 4% to HK\$201 from HK\$209 in 2002.

The use of prepaid SIM cards has continued to grow. Prepaid subscriber number increased by 54,000 or 29% to 243,000 in 2003 over 2002. ARPU from these subscribers decreased to HK\$60 in 2003 from HK\$92 in 2002 due to aggressive price promotions initiated by some operators.

The gross profit margin for mobile services was 83% in 2003, slightly better than the 82% recorded in 2002.

Wireless data services

SUNDAY remains a leader in the introduction of innovative data services. In 2003, in support of its segmentation strategy, SUNDAY expanded its proprietary Location Based Services ("LBS"). SUNDAY made very good progress in its corporate segment as market leader in enterprise LBS applications for logistics and field services management. In the mass segment, the Group launched the "Family Watch" service that allows family users to locate each other, and "SARS updates" which enabled callers to identify affected buildings in their calling areas. The Group was also the first operator in Hong Kong to offer an unlimited GPRS package and wireless LAN roaming services. Such initiatives helped data services revenue grow by 55% in 2003. Data services are still in their early stages and are expected to contribute increasingly to overall customer acquisition and retention in the future.

The data services introduced by SUNDAY to date are an important precursor to its future 3G services, since 3G technology is expected to move consumers further away from commoditised mass market of mobile voice communications towards ever more tailored multi-media mobile services.

SUNDAY's partnership with Huawei, which is a leading telecommunications equipment manufacturer based in Shenzhen, China, provides important competitive advantages for the Group. It has strengths in areas that will be critical to success in the 3G arena, including the IP core network platform and service creation as well as an end-to-end solution. The proximity of Huawei's base in Shenzhen to Hong Kong gives SUNDAY a significant edge over its rivals in developing tailor-made services and launching them quickly. The partnership and associated financing also allows SUNDAY flexibility on when and how to launch its 3G services.



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Sales of mobile phones and accessories

Revenue from sales of mobile phones and accessories decreased by HK\$6 million to HK\$109 million. The business made a gross loss of HK\$24 million as compared with a gross profit of HK\$2 million in 2002, mainly because of an extremely competitive market environment where more mobile phones were sold at subsidised prices to help upgrade existing customers for ongoing retention programmes and to acquire new customers.

FINANCIAL REVIEW

Turnover and gross profit

Total turnover for the year declined 6%, or HK\$82 million, as compared with 2002 to HK\$1,260 million. The decrease was mainly attributable to the generally weak economy, the outbreak of SARS and aggressive price promotions.

Gross profit in 2003 also decreased by 8% to HK\$930 million as compared with 2002, mainly due to lower mobile services revenue and increased handset subsidies.

Revenues from mobile services and the sales of mobile phones and accessories accounted for 91% and 9%, respectively, of the total turnover in 2003.

Operating expenses (excluding depreciation)

Operating expenses (excluding depreciation) in 2003 were reduced by 22% to HK\$619 million and fell from 65% to 54% as a percentage of mobile services revenue, as compared with 2002. This was achieved while improving service quality and was a direct result of the various efficiency improvement initiatives implemented in 2002 and 2003.

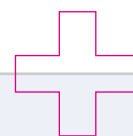
Significant savings were made in all major cost components. In particular, salary and related costs decreased by 37%, or HK\$91 million, to HK\$152 million in 2003. This largely reflects the full year effect of the restructuring of the Group's organisation and the setting up of an operations centre in Shenzhen in 2002. The new centre in Shenzhen has also provided higher productivity and better service quality.

EBITDA

EBITDA increased by HK\$101 million, or 47%, to HK\$315 million in 2003 as compared with 2002. The improvement, despite lower turnover, mainly resulted from the efficiency gains reflected by the substantial savings in operating expenses. EBITDA represents earnings before interest income, finance costs, taxation, depreciation, amortisation and share of loss from a joint venture.

Profit for the year

The Group recorded a net profit of HK\$27 million as compared with a net loss of HK\$117 million in 2002. The better performance was mainly attributable to the improvements in operating results as described above and a lower share of the loss from a joint venture.



CAPITAL EXPENDITURE

Capital expenditure for 2003 amounted to HK\$122 million, including capitalised 3G licence fees of HK\$50 million. The Group's 2G/2.5G mobile network is substantially complete. Capital expenditure incurred in 2003 was mainly for the ongoing enhancement of the mobile network for data services and expansion of the Shenzhen operations centre.

Capital expenditure for 2G/2.5G services in 2004 will decline further as the Group will focus on preparing for the rollout of its 3G network and services. It is expected that total capital expenditure for the construction of the 3G network will amount to around HK\$850 million to HK\$900 million over the next three years.

LIQUIDITY AND FINANCIAL RESOURCES

Cash flow from operations

Net cash inflow from operating activities of the Group in 2003 amounted to HK\$242 million, an increase of HK\$113 million over 2002. The increase in cash inflow from operating activities primarily resulted from the improvement in operating results as outlined above.

Financing

In 2003, the capital expenditure and working capital requirements of the Group were mainly funded by cash flow generated from operating activities. By September 2003, the outstanding revolving facility of HK\$253 million had been fully drawn down.

As at 31st December 2003, the outstanding bank loan and vendor loan balances were repayable in three quarterly instalments through September 2004, and were secured by a charge over all the assets, revenues and shares of certain subsidiaries of the Company, including Mandarin Communications Limited, the main operating subsidiary. The bank loans and vendor loans bear interest at prevailing market rates. The Group had total bank and vendor loans of HK\$721 million, and cash reserves of HK\$314 million. Net debt (total bank and vendor loans less cash reserves) amounted to HK\$407 million, and the net debt-to-equity ratio was 58% as at 31st December 2003.

In January 2004, Huawei provided a term loan of HK\$500 million through a subsidiary to SUNDAY pursuant to the terms of the Heads of Agreement executed in December 2003, which, together with available cash on hand, was used to repay outstanding vendor loans and bank loans in full. The loan from Huawei is repayable in five progressively increasing semi-annual instalments after drawdown and carries a floating interest rate tied to HIBOR. No collateral is provided by the Group.

FOREIGN EXCHANGE EXPOSURE

Substantially all revenues, expenses, assets and liabilities are denominated in Hong Kong dollars except for the US\$155 million vendor loan facility provided by Nortel. As at 31st December 2003, the outstanding vendor loan amounted to US\$62 million and this was subsequently repaid in full in January 2004.



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International roaming payables and receivables are netted and settled on a monthly basis in Special Drawing Rights (“SDR”). As at 31st December 2003, the net SDR-denominated payables were insignificant. The Group has not experienced significant foreign exchange movements and does not anticipate foreign exchange losses as long as the Hong Kong SAR Government’s policy to peg the Hong Kong dollar to the U.S. dollar remains in effect. The Group will continue monitor its foreign exchange exposure and market conditions to determine if any hedging is required.

KEY RISKS

The business performance of the Group is subject to market competition and regulatory changes. Some forward looking statements made in this annual report with respect to SUNDAY’s corporate plans or strategies are made based on management’s assumptions and beliefs in the light of the information currently available to it.

The key risks include, without limitation, the following:

- Increased competition may reduce market share or revenues;
- Delays in the development of handsets and network may hinder the deployment of new technologies;
- Expected benefits from investments in the networks, licences and new technologies may not be realised;
- Regulatory decisions and changes could adversely affect the Group’s business; and
- ARPU may not be increased by the introduction of new services.

EMPLOYEES AND SHARE OPTION SCHEME

The Group had a total of 726 employees as at 31st December 2003, of which 502 were in Hong Kong and 224 were in Shenzhen. Total salaries and related costs incurred in 2003 amounted to HK\$152 million as compared with HK\$243 million in 2002. The Group offers comprehensive remuneration and benefits packages to all employees. Remuneration of employees is maintained at competitive levels, and promotion and salary increments are assessed based on individual and Group performance. Other staff benefits include Mandatory Provident Fund schemes, subsidised medical care and subsidies for external educational and training programmes.

The Group adopted a share option scheme on 1st March 2000 (the “Old Scheme”). On 22nd May 2002, the shareholders of the Company approved the adoption of a new share option scheme (the “New Scheme”) and the termination of the operation of the Old Scheme. Upon the termination of the Old Scheme, no further options will be offered thereunder but the provisions of the Old Scheme will remain in full force and effect in respect of the existing options granted. Details of the share option schemes and the share options outstanding are disclosed in note 21 to the accounts.