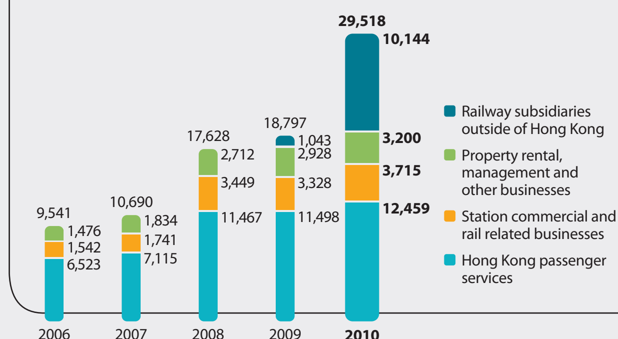
Financial Review

Turnover

Growth in turnover was recorded in all businesses in 2010 coupled with full-year contribution from railway subsidiaries outside of Hong Kong.

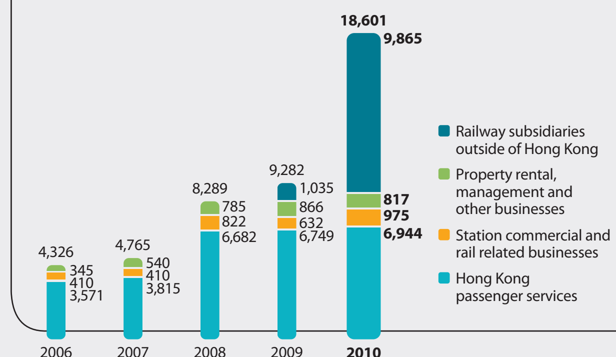
(HK$ million)



Operating Expenses

Excluding railway subsidiaries outside of Hong Kong, expense increase in 2010 was 5.9% as compared with a turnover increase of 9.1%.

(HK$ million)



Review of 2010 Financial Results

Profit and Loss

MTR leveraged off the rebound in the Hong Kong economy to record a strong financial performance in 2010.

In Hong Kong, total fare revenue in 2010 increased by 8.4% to HK$12,459 million resulting from patronage growth brought by the economic rebound and the full year impact of LOHAS Park and Austin Stations, which both opened in mid-2009, as well as a fare rise effective 13 June 2010 for those services subject to the Fare Adjustment Mechanism (FAM). Fare revenue for the Domestic Service increased by 8.5% to HK$8,668 million with patronage growth of 6.6% to 1,299 million and average fare increase of 1.9% to HK$6.67. Fare revenue for the Cross-boundary Service increased by 6.9% to HK$2,487 million with 6.3% growth in patronage to 100 million and 0.5% increase in average fare to HK$24.89. For the Airport Express, which is not subject to the FAM, fare revenue grew by 12.5% to HK$694 million with 12.9% increase in patronage to 11 million partly offset by a 0.3% decrease in average fare to HK$62.28. Light Rail, Bus and Intercity also recorded increases in fare revenue by 7.4% in total to HK$610 million.

Revenue from station commercial and rail related businesses in 2010 increased by 11.6% to HK$3,715 million mainly attributable to the strong recovery of the advertising business, which reported 22.9% growth in revenue to HK$734 million, as well as favourable rate and rentable area increases in the station retail business, which recorded 6.9% increase in revenue to HK$1,716 million. Telecommunication income increased steadily by 6.2% to HK$290 million while other miscellaneous incomes, such as publications and souvenir ticket sales, grew by 4.5% to HK$278 million. These revenue increases were partially offset by decreases of consultancy and freight revenues by 28.9% and 15.6% respectively following the completion of certain consultancy works and termination of the freight business. Revenues from KCRC and the Government, mainly in respect of the entrustment works for the Express Rail Link (XRL) commencing in 2010 and project management for the Kowloon Southern Link, amounted to HK$557 million, up 40.7% from last year.

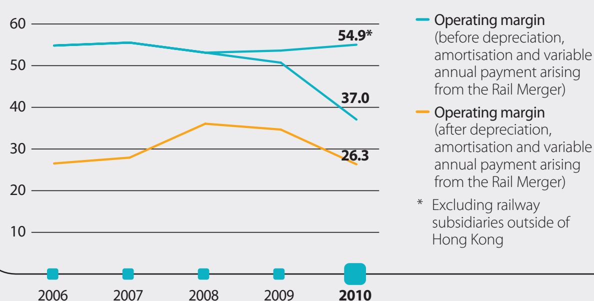
Rental, management and other revenue in 2010 increased by 9.3% to HK$3,200 million. Whilst good rental reversions for investment properties in Hong Kong contributed to the growth in property rental and management income by 7.5% to HK$2,961 million, the increases in tourists and demand for the "crystal cabin" led to a strong growth in revenue for Ngong Ping 360 with revenues increasing by 38.2% to HK$239 million.

Revenues from railway subsidiaries outside of Hong Kong in 2010 amounted to HK$10,144 million, comprising HK$2,858 million from the Stockholm Metro and HK$7,239 million from Melbourne Metropolitan Train, both of which we took over in

Operating Margin

Steady growth in operating margin excluding railway subsidiaries outside of Hong Kong has been achieved since the Rail Merger.

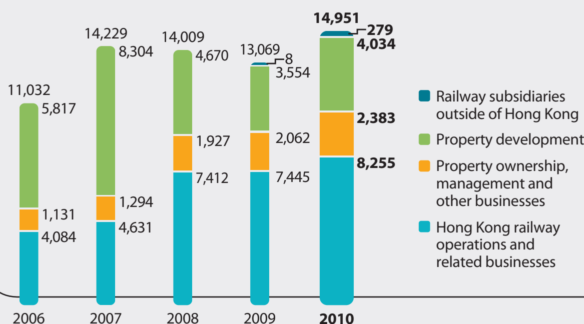
(Percentage)



Operating Profit Contributions

While Hong Kong railway operations and related businesses continued to be the majority profit contributor, railway subsidiaries outside of Hong Kong contributed 1.9% of profit in 2010.

(HK$ million)



November 2009, and HK$47 million from Phase 1 of Shenzhen Metro Line 4 (SZL4), which MTR took over on 1 July 2010. Total revenue for the Group in 2010 including these subsidiaries therefore increased by 57.0% to HK$29,518 million. Excluding these subsidiaries outside of Hong Kong, revenue grew by 9.1%.

Total operating expenses before depreciation, amortisation and variable annual fee payable as part of the service concession payment to KCRC increased by 100.4% to HK$18,601 million mainly due to the expansion of the railway operations outside of Hong Kong. Excluding operating costs on railway subsidiaries outside of Hong Kong of HK$9,865 million, the growth in operating expenses would have been 5.9%. The major cost increases came from the Express Rail Link entrustment work costs, full-year operation of the LOHAS Park and Austin Stations as well as higher advertising agency fees, Octopus card transaction fees and operating expenses of Ngong Ping 360 in line with revenue growth.

The resulting operating profit from railway and related businesses before depreciation, amortisation and variable annual payment increased by 14.7% to HK$10,917 million. Owing to the full-year operation of the asset-light and lower profit-margin railway subsidiaries in Stockholm and Melbourne, as well as the operating loss of SZL4 Phase 1 for the initial period after we took over operations in July 2010, operating profit margin in 2010 decreased from 50.6% in 2009 to 37.0%. Excluding these railway subsidiaries outside of Hong Kong, profit margin actually increased from 53.5% in 2009 to 54.9% in 2010 with operating profit increasing by 11.9% to HK$10,638 million.

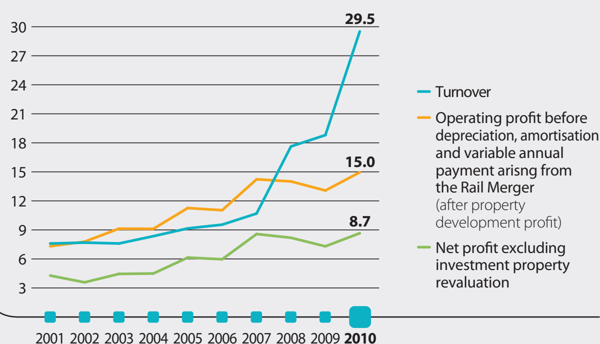
Profit on property development in 2010 increased by 13.5% to HK$4,034 million mainly derived from Le Prestige at LOHAS Park and sale of units in inventory at The Palazzo in Fo Tan and Lake Silver in Wu Kai Sha. After deducting depreciation and amortisation of HK$3,120 million, which increased by 4.3% mainly due to the full-year charge for the LOHAS Park Station, and the one-month provision of variable annual payment of HK$45 million, which started at the end of 2010, being the third anniversary of the Rail Merger, operating profit before interest and finance charges increased by 17.1% to HK$11,786 million.

Interest and finance charges decreased by 17.8% to HK$1,237 million due to the scheduled debt repayment and prepayment of floating rate bank loans with surplus cash, thus resulting in lower outstanding debts. However, the weighted average cost of borrowing, at 4.3%, was higher when compared with 3.7% in 2009. Pre-tax investment property revaluation gain recognised in 2010 was HK$4,074 million. As a result of Octopus's one-off expenditures relating to the data privacy incident, the Group's

Net Results from Underlying Businesses

Underlying business profit reported a record peak in 2010.

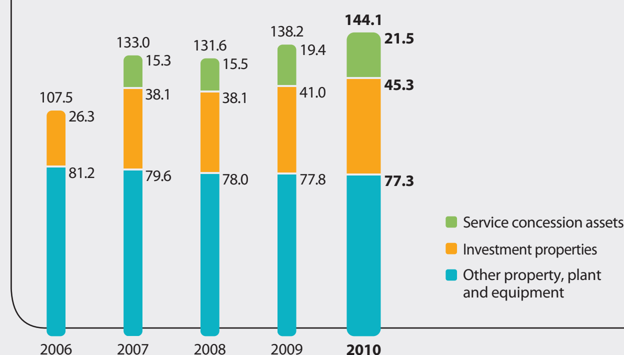
(HK$ billion)



Fixed Assets Growth

Fixed assets increased in 2010 with investment property revaluation gains and recognition of service concession assets relating to Shenzhen Line 4.

(HK$ billion)



share of net profit of non-controlled subsidiaries and associates in 2010 decreased by 13.1% to HK$139 million, comprising profits of HK$126 million from Octopus Holdings Limited and HK$13 million from our rail related associated companies outside of Hong Kong.

Profit before taxation increased by 28.2% to HK$14,762 million. After deducting income tax of HK$2,590 million, profit for 2010 increased by 26.3% to HK$12,172 million, of which HK$12,059 million, an increase of 25.1% from last year, was attributable to equity shareholders of the Company. Earnings per share therefore increased from HK$1.69 in 2009 to HK$2.10 in 2010. Excluding investment property revaluation and the related deferred tax provision, the underlying profit attributable to equity shareholders increased by 18.5% to HK$8,657 million and the corresponding earnings per share increased from HK$1.28 to HK$1.51.

Following our progressive dividend policy, the Board has recommended a final dividend of HK$0.45 per share, which, when added to the interim dividend of HK$0.14 per share, will bring full year dividend to HK$0.59 per share, an increase of HK$0.07 per share or 13.5% compared with last year. The final dividend, amounting to HK$2,598 million in total, offers a scrip dividend option to all shareholders except those with registered addresses in the United States of America or any of its territories or possessions.

Balance Sheet

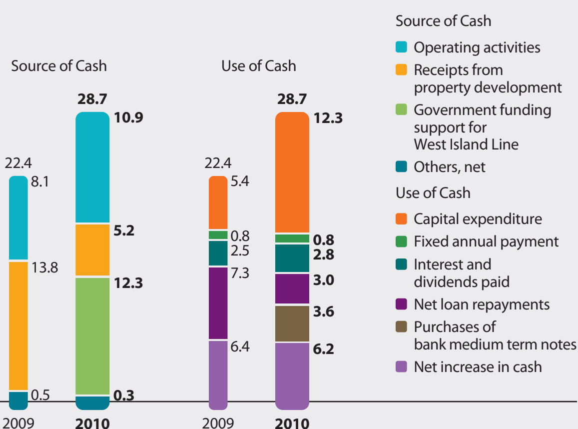
As at 31 December 2010, net assets of the Group increased by 10.2% from 2009 year end to HK$117,293 million, attributable to a 2.9% increase in total assets to HK$181,665 million and 8.1% decrease in total liabilities to HK$64,372 million.

On the asset side, total fixed assets increased by HK$5,869 million to HK$144,057 million at 31 December 2010 as a result of the revaluation gain in investment properties and the recognition of service concession assets relating to the takeover of Phase 1 and continued construction progress of Phase 2 of SZL4. Property development in progress increased from HK$6,718 million to HK$9,128 million mainly due to the contribution of land premium for Austin Station Sites C and D partly offset by profit recognition of Le Prestige. Properties held for sale decreased from HK$3,783 million to HK$1,936 million with sales mainly from The Palazzo and Lake Silver during the year. Deferred expenditure relating mainly to the South Island Line (East) and the Kwun Tong Line Extension increased from HK$558 million to HK$1,079 million.

Cash Utilisation

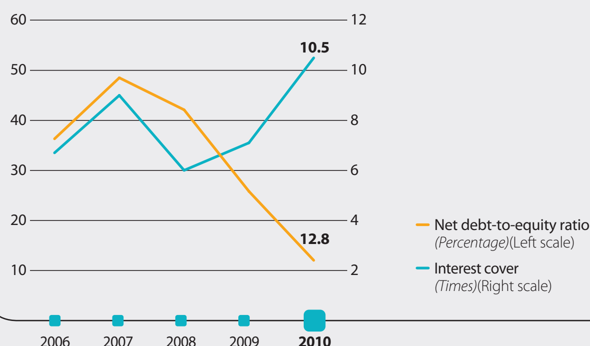
WIL Government funding support received in 2010 was utilised to pay capital expenditures, repay borrowings and purchase bank medium term notes.

(HK$ billion)



Debt Servicing Capability

Interest cover and gearing ratio were further enhanced with the growth in profit and reduction in debts.



During the year, funding support from the Government for the West Island Line (WIL) of HK$12,252 million was received, thus reducing the amounts due from Government and other related parties from HK$12,788 million to HK$330 million and contributing to the additions in investments in securities from HK$227 million to HK$3,912 million and cash, bank balances and deposits from HK$7,115 million to HK$13,334 million. As the cumulative construction costs for the WIL at HK$5,077 million was still below the Government funding support, railway construction in progress at 31 December 2010 continued to report a zero balance. With the full-year operation of overseas railway subsidiaries, debtors, deposits and payments in advance increased from HK$2,428 million to HK$3,057 million.

On the liability side, the major reduction in liabilities came from creditors and accrued charges and total loans outstanding. Creditors and accrued charges decreased from HK$20,497 million at 2009 year end to HK$15,491 million at 31 December 2010 due to the utilisation of WIL Government funding support of HK$3,392 million during the year as well as the transfer to property development profits of HK$2,963 million of pre-sales receipt from Le Prestige, received in 2009, on recognition of development profits in 2010. Total loans outstanding decreased from HK$23,868 million to HK$21,057 million as surplus cash generated were applied to repay debts. These reductions in liabilities were partially offset by an increase in current and deferred tax liabilities of HK$1,638 million to HK$14,872 million, of which HK$1,018 million related to current tax, and an increase in deferred income from HK$167 million to HK$605 million due to the receipt of guaranteed profits in respect of Festival City at Tai Wai.

Share capital, share premium and capital reserve increased by HK$1,237 million to HK$43,734 million at 31 December 2010 resulting from shares issued for scrip dividends and share options exercised. Together with the increase in retained earnings, net of dividends paid, of HK$9,076 million and increase in fixed asset revaluation reserve and other reserves of HK$450 million, total equity attributable to shareholders of the Company increased by HK$10,763 million to HK$117,150 million at 31 December 2010. Including obligations under service concession and loan from holders of non-controlling interests as components of debt and investments in bank medium term notes as component of cash, net debt-to-equity ratio decreased from 25.8% at 2009 year end to 12.8% at 2010 year end.

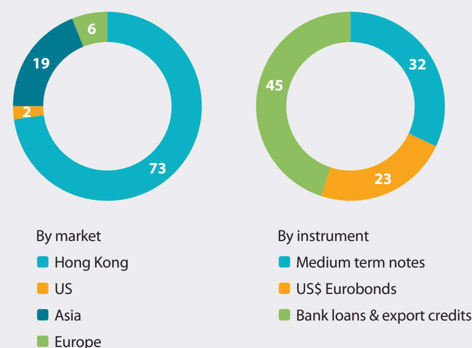
Cash Flow

In line with the growth in operating profits, net cash inflow from operating activities of the Group, after cash tax payments, in 2010 increased by 34.5% to HK$10,907 million. During

Sources of Borrowing

Although Hong Kong is our main market, our strategy is to diversify our funding sources and maintain ready access to other important international markets.

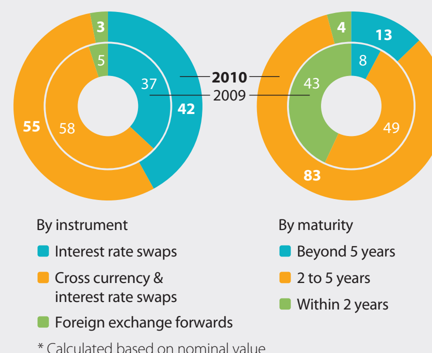
(Percentage) (As at 31 December 2010)



Use of Interest Rate and Currency Risk Hedging Products

The Company uses derivative financial instruments for hedging purposes, and has a strict policy of limiting their usage for such purposes only.

(Percentage)* (As at 31 December 2010)



* Calculated based on nominal value

the year, cash receipt in respect of property developments amounted to HK$5,249 million, mainly coming from The Palazzo, Le Prestige and Lake Silver as well as the guaranteed profit for Festival City. Including other cash receipts such as dividends from non-controlled subsidiaries and recovery of Government entrustment work costs, cash inflow in 2010 before accounting for the WIL Government funding support and financing activities was HK$16,322 million.

Cash outflows for capital projects and property developments in 2010 amounted to HK$12,336 million, comprising HK$5,766 million for railway construction projects such as WIL and SZL4, HK$1,953 million for the purchase of Hong Kong railway operational assets and HK$4,617 million for property developments including the land premium for Austin Station Sites C and D of HK$3,900 million. After settlement of the fixed annual payment for the Rail Merger of HK$750 million, net interest payment of HK$757 million, dividend payments of HK$1,872 million and other working capital adjustments, total cash outflows before loan repayment was HK$15,711 million.

Net cash inflow of HK$611 million was generated in 2010 before receipt of the WIL Government funding support. Including the WIL Government funding support of HK$12,252 million received in March 2010, total net cash inflow of the Group before financing activities was HK$12,863 million, of which HK$3,015 million was utilised to reduce debts while HK$3,624 million was invested in bank medium term notes. Cash balance of the Group therefore increased by HK$6,224 million to HK$13,318 million at 31 December 2010.

Financing Activities

Financings

For much of 2010, the US economy grew at a slow rate with all major economic indicators painting a picture of continuing slow growth and high unemployment. To stimulate growth, the US Federal Reserve in the fourth quarter embarked on a second round of quantitative easing measures and the US government extended tax cuts from the previous administration. Against this backdrop, US short-term interest rates remained low whilst longer term rates were volatile. The yield on 10-year US treasuries reached a low of 2.4% p.a. in October but closed the year at 3.3% p.a. with a significantly steepened yield curve.

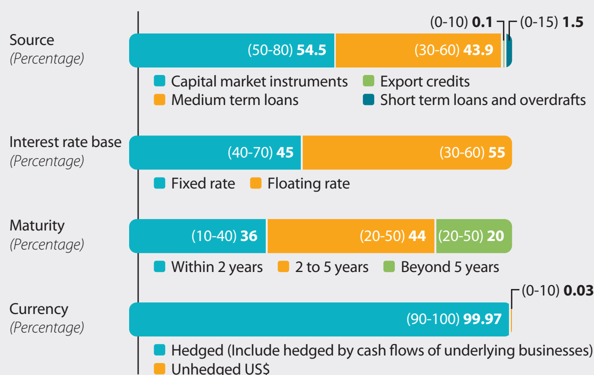
Interest rates in Hong Kong followed the US trends, with 3-month Hibor rate oscillating between 0.12% p.a. and 0.57% p.a., closing the year at 0.28% p.a.. 10-year Hong Kong Exchange Fund Notes yield reached a low of 1.9% p.a. in August and closed the year at 2.9% p.a., compared with 2.6% p.a. a year ago.

Throughout the year, the Group was in a very liquid position, benefiting from strong cash flows from operation and property development as well as receipt of substantial funding support from the Government for the construction of WIL. The Company did not raise any new financing as available cash and investments, combined with anticipated cash inflow and undrawn committed banking facilities, are expected to be sufficient to cover all funding requirements, including debt refinancing and capital expenditure, well into 2012.

Preferred Financing Model and Debt Profile

The Preferred Financing Model exemplifies the Company's prudent approach to debt management and helps ensure a well balanced debt portfolio.

(Preferred Financing Model) vs. **Actual debt profile** As at 31 December 2010



Cost of Borrowing

Total loans outstanding declined from HK$23,868 million at the end of 2009 to HK$21,057 million at the end of 2010 due to scheduled debt repayment and prepayment of bank loans with cash surplus. The Group's weighted average borrowing cost for 2010 was 4.3% p.a., up from 3.7% p.a. in 2009 as a result of substantial prepayment of floating rate bank loans which gave rise to a higher portion of debt being denominated in higher fixed interest rates. However, net interest expense charged to the Profit and Loss Account, after interest capitalised of HK$100 million, declined to HK$1,237 million from HK$1,504 million in 2009 due to reduced borrowings.

Treasury Risk Management

The Board of Directors approves policies for overall treasury risk management. The Group's well established Preferred Financing Model (the "Model") is an integral part of these risk management policies. The Model specifies the preferred mix of fixed and floating rate debts, sources of funds from capital and loan markets, debt maturity profile, a permitted level of foreign currency debts, and an adequate length of financing horizon for coverage of forward funding requirements. During 2010, in accordance with the Model the Group maintained a well diversified debt portfolio with adequate forward coverage of funding requirements.

The use of derivative financial instruments to control and hedge against interest rate and foreign exchange risk exposures forms an integral part of the Group's risk management strategy. In accordance with Board policy, these instruments shall only be used for controlling or hedging risk exposures, and cannot be used for speculative purposes.

To control and diversify counterparty risks, the Group limits its exposure to credit risk by only placing deposits and transacting derivative financial instruments with, or investing in instruments issued by, financial institutions and companies with acceptable investment grade credit ratings.

All derivative financial instruments are subject to a maximum counterparty limit based on the respective counterparty's credit ratings in accordance with policy approved by the Board. Credit exposure in terms of estimated fair market value of and largest potential loss arising from these instruments based on the "value-at-risk" concept is measured, monitored and controlled against their respective counterparty limits. To further reduce risk exposure, the Group also applies set-off and netting arrangements across all derivative financial instruments and other financial transactions with the same counterparty.

All bank deposits and medium term notes investments are similarly subject to a separate counterparty limit based on the respective counterparty's credit ratings and/or status as Hong Kong's note issuing bank. There is also a limit on the length of time that the Group can maintain a deposit with or invest in an instrument issued by a counterparty based on credit ratings. Deposit outstanding and maturity profile are monitored on a frequent basis to ensure they are within the approved limits.

The Group actively monitors credit ratings and credit related changes of all its counterparties using such additional information as the counterparties' credit default swap levels, and would on the basis of all such information adjust the maximum counterparty limits of, and/or credit exposure to, its counterparties.

The Group adopts a prudent approach to managing liquidity risk, and will maintain sufficient cash balance and undrawn committed banking facilities to provide forward coverage of at least 6 to 15 months of all projected cash requirements, including debt repayments and capital expenditures, as specified by the Model. The Group also conducts stress testing of its projected cash flow to analyse liquidity risk, and would arrange additional banking facilities or debt issuance or otherwise take appropriate actions if such stress tests reveal significant risk of material cash flow shortfall.

Credit Ratings

In November, Moody's upgraded the government bond rating of the Hong Kong SAR government from "Aa2" to "Aa1", and at the same time revised the Company's issuer and senior unsecured debt ratings from "Aa2" to "Aa1", bringing them on par with the HKSAR government's sovereign rating. The rating outlook is stable.

In December, Hong Kong became one of the few countries and regions in the world that were given the highest credit rating when Standard & Poor's ("S & P's") raised the long-term issuer credit rating on Hong Kong SAR from "AA+" to "AAA". In line with the rating action, S & P's raised the Company's long-term corporate credit rating from "AA+" to "AAA" with stable outlook, the highest credit rating ever achieved in the Group's history.

Earlier, Rating & Investment Information, Inc. of Japan had also affirmed the Company's foreign currency issuer and Hong Kong dollar issuer ratings at "AA+", and Hong Kong dollar short-term credit rating at "a-1+", with a stable outlook.

Financing Capacity

The Group's capital expenditure programme consists mainly of three parts – railway projects in Hong Kong, property investment and development in Hong Kong, and overseas investments.

Capital expenditure for railway projects in Hong Kong comprises mainly investment in and expenditures relating to new railway projects, including ownership projects such as WIL, South Island Line (East) and the Kwun Tong Line Extension, as well as outlays for maintaining and upgrading the existing rail lines. Concession projects such as the Shatin to Central Link and XRL will be fully funded by the Government and therefore for funding purposes have not been included in the Group's projected capital expenditure.

Capital expenditure for property investment and development comprises mainly enabling works for property development, payment of land premium, as applicable, as well as fitting-out and refurbishment works of shopping centres. Expenditure for overseas investments consists primarily of capital expenditure for SZL4 project and equity injection for the Hangzhou Line 1 project.

Based on current programmes, total net capital expenditures for the next three years of 2011, 2012 and 2013 are estimated at HK$34.6 billion for railway projects in Hong Kong, HK$2.7 billion for property investment and development in Hong Kong, and HK$5.8 billion for overseas investments, for a total of HK$43.1 billion. Out of this total, it is estimated that HK$16.4 billion would be incurred in 2011, HK$14.8 billion in 2012, and HK$11.9 billion in 2013.

With forward financing coverage extending well into 2012, the Group's funding requirement including debt refinancing and net capital expenditure in 2011 and most of 2012 is expected to be well taken care of by the Group's existing cash and investment as well as future projected cash flow.

Credit ratings	Short-term ratings*	Long-term ratings*
Standard & Poor's	A-1+/A-1+	AAA/AAA
Moody's	-/P-1	Aa1/Aa1
Rating & Investment Information, Inc. (R&I)	a-1+	AA+

* Ratings for Hong Kong dollar/foreign currency denominated debts respectively