
FINANCIAL INFORMATION

INDEBTEDNESS

Save as disclosed in this document and apart from intra-group liabilities, the Group did not have outstanding at the close of business on 30th April, 2000 any loan capital, bank overdrafts and liabilities under acceptances or other similar indebtedness, debentures, mortgages, charges or loans or acceptance credits or hire purchase commitments, guarantees or other material contingent liabilities.

Amounts referred to in this indebtedness statement denominated in currencies other than Hong Kong dollars have been converted into Hong Kong dollars at the relevant rates of exchange prevailing at the close of business on 30th April, 2000.

Borrowings

As at the close of business on 30th April, 2000, being the latest practicable date for the purpose of this indebtedness statement prior to the printing of this document, the Group had no outstanding bank borrowings.

Security for borrowings

As at 30th April, 2000, the Group's total available credit facilities of approximately HK\$3,274 million were secured by the following:

- fixed rate instruments under securities repurchase facilities of HK\$2,070 million;
- bank deposits of HK\$10 million for an overdraft facility;
- bank deposits of HK\$4 million in relation to a guarantee provided by a bank in lieu of rental deposits for certain office premises;
- corporate guarantees of HK\$80 million executed by a subsidiary of the Company against a facility for discounting foreign currency cheques;
- a debenture creating a floating charge over HKSCC's assets for standby facilities of HK\$1 billion for meeting HKSCC's obligations in CCASS in circumstances where CCASS Participants default on their payment obligations; and
- a corporate undertaking issued by HKSCC for the repayment of overdraft facilities.

As at 30th April, 2000, the Group had utilised bank guarantees of about HK\$6 million.

Contingent liability

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 Stock Exchange Participants, up to HK\$200,000 in respect of defaults of any one participant. In the unlikely event that all of its 499 trading Stock Exchange Participants as at 30th April, 2000 default, the maximum contingent liability of the Stock Exchange under the indemnity would amount to HK\$99.8 million.

FINANCIAL INFORMATION

No material change

The Directors have confirmed that there has not been any material change in the indebtedness or contingent liabilities of the Group since 30th April, 2000.

PRACTICE NOTE 19 TO THE LISTING RULES

The Directors have confirmed that, as at the Latest Practicable Date, they were not aware of any circumstances which would give rise to a disclosure requirement under Practice Note 19 of the Listing Rules.

LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE

Net current assets

As at 31st December, 1999, the Group had total audited net current assets of approximately HK\$2,664 million.

Audited current assets comprised bank balances and time deposits of approximately HK\$3,297 million, margin funds on derivatives contracts of approximately HK\$5,860 million, accounts receivable, prepayments and deposits of HK\$2,831 million, non-trading securities maturing within one year of HK\$294 million and taxation recoverable of HK\$12 million. The assets representing margin funds consisted mainly of bank balances and fixed rate instruments. The accounts receivable consisted mainly of obligations under the CNS System.

Audited current liabilities comprised bank borrowings in respect of repurchase agreements of HK\$204 million, margin deposits received on derivatives contracts of HK\$5,656 million, accounts payable, accruals and deposits received of HK\$3,349 million, deferred revenue of HK\$192 million, payable to the Compensation Fund of HK\$200 million and taxation payable of HK\$28 million. The bank borrowings under repurchase agreements are borrowings secured by fixed rate instruments held by the margin funds. The accounts payable consisted mainly of obligations under the CNS System. Margin deposits are received from SEOCH and HKCC Participants and are refundable to them when they close out their positions in derivatives contracts traded on the Stock Exchange and the Futures Exchange.

Capital commitments

As at 31st December, 1999, the Group had capital commitments of approximately HK\$242 million in respect of the development of computer systems and leasehold improvements of which HK\$89 million had been contracted but not provided for and HK\$153 million had been authorised but not contracted for.

FINANCIAL INFORMATION

TRADING RECORD

The audited combined results of the Group for each of the three financial years ended 31st December, 1999 (the "Relevant Period"), prepared on the basis that the existing Group structure had been in place throughout the Relevant Period and based on the accountants' report the text of which is set out in Appendix I to this document, are summarised below:

Summary of combined results of the Group

	1999 HK\$'000	1998 HK\$'000	1997 HK\$'000
Turnover			
Transaction levy, trading tariff and fees from			
- securities and options traded on the Stock Exchange	314,449	262,787	590,681
- derivatives contracts traded on the Futures Exchange	113,086	142,970	142,590
Clearing and settlement fees from			
- securities traded on the Stock Exchange	191,759	191,171	554,845
- derivatives contracts traded on the Futures Exchange	4,501	5,446	5,944
Interest income	657,732	1,051,844	653,771
Income on providing information	229,074	246,492	191,033
Listing fees	205,594	196,635	219,728
Depository, custody and nominee services fees	143,702	247,159	260,525
Stock Exchange terminal user fees	45,467	43,995	27,613
Other fees	58,100	56,168	62,708
	<u>1,963,464</u>	<u>2,444,667</u>	<u>2,709,438</u>
Other revenue			
Gross rental income	1,236	2,026	2,462
Income received from former clearing house	7,024	675	75,583
Other income	27,418	32,345	37,495
	<u>1,999,142</u>	<u>2,479,713</u>	<u>2,824,978</u>
Total revenue			
Staff costs and related expenses	528,466	521,564	476,282
Retirement benefit costs	46,018	49,234	36,336
Maintenance and network expenses	134,672	121,327	92,604
Operating lease rentals			
- land and buildings	81,597	82,669	78,246
- equipment	52,927	55,271	27,671
Legal and professional fees	39,553	48,048	20,784
Interest expense	174,863	364,454	228,989
Depreciation	150,197	168,260	188,424
Special contribution to Unified Exchange			
Compensation Fund	13,103	236,897	—
Re-organisation costs	60,835	—	—
Other operating expenses	159,752	159,828	130,862
	<u>1,441,983</u>	<u>1,807,552</u>	<u>1,280,198</u>
Profit before taxation	557,159	672,161	1,544,780
Taxation	36,493	47,049	192,739
	<u>520,666</u>	<u>625,112</u>	<u>1,352,041</u>
Profit for the year			

FINANCIAL INFORMATION

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following should be read in conjunction with the Group's audited financial statements and notes thereto included in Appendix I to this document.

Revenues

The principal sources of the Group's revenues comprise trading fees collected by the Exchanges, clearing and settlement fees, interest income on margin funds earned primarily by HKCC and interest on surplus cash, income from the sale of information by the Exchanges, listing fees charged by the Stock Exchange, and depository, custody and nominee services fees charged by HKSCC. A brief description of these principal revenue sources is set out below:

(a) *Trading Fees*

Trading fees comprise Stock Exchange transaction levy, Stock Exchange trading tariff and Futures Exchange trading fee.

(i) Stock Exchange transaction levy

The Stock Exchange charges a transaction levy, calculated as a percentage of the consideration, payable by each of the purchaser and vendor/issuer, on each of the following transactions:

- the purchase or sale of securities listed or approved to be listed on the Stock Exchange carried out by a Stock Exchange Participant or dealing partnership whether as principal or agent;
- the subscription and/or purchase of securities of a class new to listing;
- the subscription and/or purchase of securities of a class already listed under an offer made to the public by or on behalf of a listed issuer, excluding a rights issue or open offer; and
- any other transaction in securities of a class new to listing which the Stock Exchange deems appropriate.

Income from transaction levy is dependent upon the dollar volume of trades on the Stock Exchange (both primary and secondary market trades), the rate at which the levy is charged and the proportion of the levy retained by the Stock Exchange. The rate at which transaction levy is charged is prescribed in orders made by the Chief Executive of Hong Kong in Council pursuant to the Securities and Futures Commission Ordinance, and the levy is required by that Ordinance to be shared between the Stock Exchange and SFC in the proportions prescribed for the time being. During 1997 to 1999, the rate at which transaction levy was charged was reduced from 0.013 per cent. to 0.011 per cent. through a 0.002 per cent. reduction in the amount of levy payable to the SFC. However, with effect from 12th June, 2000 the Stock Exchange's share of the levy has been reduced from 0.007 per cent. to

FINANCIAL INFORMATION

0.005 per cent. while the SFC's portion has been increased by 0.001 per cent. in recognition of certain regulatory functions having been transferred from the Exchanges to the SFC, as described in the section of this document headed "Business — history and development", following completion of the merger of the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group under HKEx. Further changes, including the possible abolition of the Stock Exchange's right to receive any share of transaction levy, may be implemented in the future, as described below.

(ii) Stock Exchange trading tariff

A trading tariff of HK\$0.50 is payable by both the buying and selling broker to the Stock Exchange on each purchase and sale of securities on the exchange. The tariff rate is set out in the rules of the Stock Exchange.

(iii) Futures Exchange trading fee

A trading fee is charged by the Futures Exchange on each contract traded on the Futures Exchange. The trading fee varies, currently from HK\$1.50 to HK\$10.00 per contract, depending on the type of contract traded.

(b) *Clearing and settlement fees*

Substantially all of the clearing and settlement fees of the Group comprise fees charged by HKSCC on trades and transactions settled through CCASS. Such fees are charged as a percentage of the value of the trade or transaction. HKSCC has been steadily lowering its fees to reflect its historical mission to lower transaction costs in Hong Kong. As a result, such fees were decreased from 0.005 per cent. to 0.004 per cent. in July 1997, to 0.0025 per cent. in January 1998 and to the current rate of 0.002 per cent. in November 1998. Following the merger of the Exchanges and Clearing Houses HKSCC will, in setting its fees, need to consider among other things its obligations to maintain the integrity of the market and the commercial profit making objectives of the Group. In addition, as referred to in the section of this document headed "Industry overview — Hong Kong's stock and futures markets", the fees imposed by HKSCC are required by the Merger Ordinance to be set out in its rules and approved by the SFC.

(c) *Interest income*

(i) Margin

As part of its risk management measures HKCC collects margin on open contracts. The great majority of the margin collected is in the form of cash, which is invested by the Group in money market instruments and/or placed on deposit to earn interest. The amount of interest income received is highly dependent upon the level of activity on the Futures Exchange in terms of the number of open contracts, the volatility of the futures market, the mix of cash and non-cash collateral accepted by HKCC, and prevailing interest rates. For margin collected in the form of cash, a fixed percentage of the interest earned (the "retention rate") is retained by HKCC while a variable percentage determined according to the implied overnight hibid rate (for HK\$), implied overnight repo offer rate (for US\$) or deposit rate (for Yen) (the "base

FINANCIAL INFORMATION

rate”), less the retention rate, is paid to HKCC Participants as interest. Income may also be earned by HKCC on the spread between income earned on the margin funds and the base rate. For margin collected in the form of non-cash collateral, HKCC levies a charge equivalent to the retention rate on the value of the non-cash collateral utilised as cover for required margin. The majority of the Futures Exchange Group's income comprises interest income on margin on open contracts and the level of margin required by the Futures Exchange Group on open contracts may be greater when volatility is higher.

In addition to HKCC, SEOCH earns interest income on margin collected on open contracts but this only represents a very small proportion of the Group's total interest income.

(ii) *Cash balances*

Interest is also earned by the Group on its surplus cash.

(d) *Sale of information*

The Stock Exchange provides market information to a variety of users, including information vendors, market data feed subscribers and teletext subscribers. Information vendors gather the required information from multiple sources and package and redistribute it to market end users such as Stock Exchange Participants, investment banks, fund managers, academics and market participants generally. The Stock Exchange also provides historical trading information to private investors and others on an ad hoc basis.

The Futures Exchange also derives income from the sale of information but this only represents a very small proportion to the Group's income from sale of information.

(e) *Listing fees*

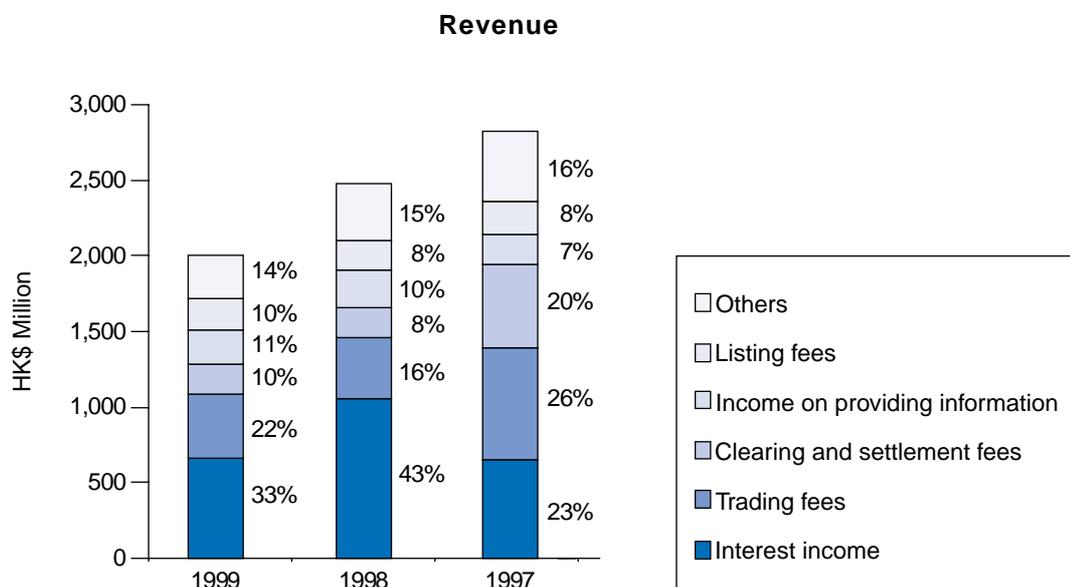
Income from listing fees comprises initial listing fees, annual listing fees and subsequent issue fees. Initial listing fees are payable to the Stock Exchange upon the listing of a new applicant. Annual listing fees are payable in respect of each class of securities listed on the Stock Exchange and subsequent issue fees are payable upon subsequent issues of equity securities.

(f) *Depository, custody and nominee services fees*

These fees charged by HKSCC comprise registration and transfer fees on nominee services, stock custody fees, dividend collection fees, stock withdrawal fees and other nominee services fees relating to CCASS.

FINANCIAL INFORMATION

The composition of the major income items of the Group for the three years ended 31st December, 1999 is set out below:



In light of the Group's status as the sole operator of the exchange-based stock and futures markets in Hong Kong, the fees imposed by HKEx in its capacity as controller of the Exchanges and Clearing Houses and the fees imposed by the Exchanges and Clearing Houses in their respective capacities as exchanges and clearing houses are required under the Merger Ordinance to be set out in their rules and approved by the SFC. The making of, and changes to, the rules of HKEx, the Exchanges and the Clearing Houses require the approval of the SFC. In deciding whether or not to approve a fee or changes to a fee the SFC is required by the Merger Ordinance to have regard to (i) the level of competition, if any, in Hong Kong for the matter for which the fee is to be imposed, and (ii) the level of fee, if any, imposed by similar bodies inside or outside Hong Kong for the same or a similar matter.

The Government has publicly stated its objective to reduce transaction costs in order to enhance the competitiveness of the securities market in Hong Kong. More recently, in accordance with this initiative and with effect from 12th June, 2000, transaction levy has been reduced from 0.011 per cent. to 0.010 per cent. of the value of a trade, and the Stock Exchange's share has been reduced to 0.005 per cent., as described above. In addition, in line with the Group being a profit driven, commercial entity, the Board anticipates that the Stock Exchange will in due course cease to retain any portion of the transaction levy and will, in lieu and subject to the approval of the SFC, impose a user transaction fee (the time at which either or both of these events will occur is currently unknown).

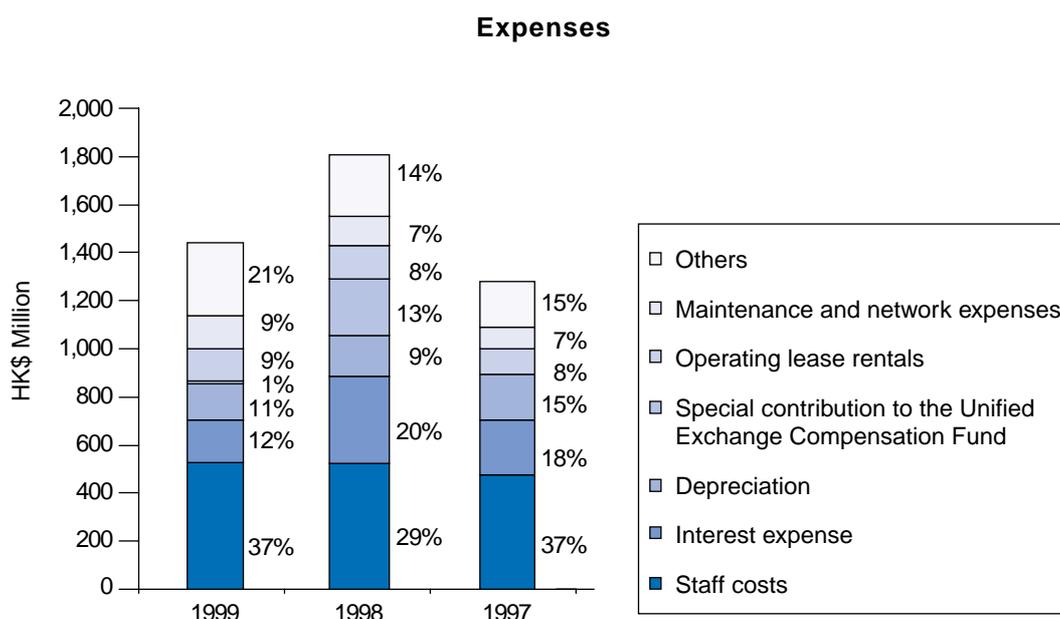
FINANCIAL INFORMATION

Expenses

The Group's principal operating expenses are staff costs and related expenses, interest expenses, maintenance and network expenses, operating lease rentals and depreciation. Of these the largest component is staff costs due to the fact that the Group is essentially a services business. Interest expenses principally comprise interest paid to HKCC Participants on margin funds as described above. Maintenance and network expenses comprise expenses relating to the upkeep and maintenance of computer systems. Depreciation charges relate primarily to the writing off of the capitalised costs of computer systems, including hardware and software. Operating lease rentals are lease costs for office premises and computer systems used in the Group's trading platforms.

In addition to operating expenses, the Group has made special contributions to the Compensation Fund, recorded as expenses of the Group, as described below and in the section of this document headed "Business — business of the Group".

The composition of the major expense items of the Group for the three years ended 31st December, 1999 is set out below:



General Overview

In general, trading fees, income from the sale of information and clearing and settlement fees fluctuate depending on the level of activity on the Stock Exchange in terms of dollar volume, while interest income fluctuates depending on the level of activity on the Futures Exchange in terms of the number of open contracts and the volatility of the futures market.

FINANCIAL INFORMATION

During the last three financial years the levels of activity on both Exchanges were primarily, and significantly, affected by three key events, namely:

- *the return of Hong Kong to mainland China sovereignty in July, 1997* — this created a heightened focus on, and interest in, Hong Kong internationally and generated positive investor sentiment, particularly toward H share and red chip companies, which translated into exceptional primary and secondary trading activities on the Stock Exchange in the second and third quarters of 1997;
- *the economic crisis* — this followed the devaluation of the Thai baht in July, 1997 and resulted in pressure being brought to bear on the currency link between the US and the Hong Kong dollar, causing extreme and exceptional fluctuations in interest rates for Hong Kong dollar deposits and triggering extreme volatility in the Hang Seng Index as the Government waged a successful defence of the link by actively participating in the stock and futures markets; and
- *the economic recession in Hong Kong* — this resulted from the economic crisis and is continuing to affect investor sentiment, the profitability of listed companies and other businesses in Hong Kong and asset prices generally.

The Directors believe that the combination of these three events distorted normal trading patterns in the markets in the following manner:

- prior to the onset of the economic crisis, the Hang Seng Index had trended upwards (from 10,073 and 13,451 at the end of December 1995 and 1996, respectively) and reached a historical high of 16,673 in August, 1997. With the onset of the economic crisis the index entered a downward trend and the markets entered a period of high volatility as speculation centered on the viability of the Hong Kong dollar's link to the US dollar. The Hang Seng Index reached a low of 6,660 in August, 1998 (an approximately 60.1 per cent. decrease from August, 1997) before recovering to 16,962 at the close of 1999;
- on the main board of the Stock Exchange, trading volume, as measured by dollar value, almost doubled between 1996 and 1997 to reach a historical high of HK\$3,789 billion in 1997 while turnover velocity was an average of 110 per cent. during the year. However, trading volume began to fall in the last quarter of 1997 when the economic crisis began to impact on Hong Kong and negatively affect investor sentiment, and in 1998 volume was a more modest HK\$1,701 billion (an approximately 55.1 per cent. decrease from 1997) notwithstanding the boost provided by the Government purchasing over HK\$118 billion of securities on the market in its defence of the currency link. Turnover velocity also fell significantly to an average of 60 per cent. during 1998. In 1999, with the Hong Kong economy in recession, trading volume on the Stock Exchange stabilised at HK\$1,916 billion. While this amount was significantly below 1997 trading volume, it was still significantly above trading volume in 1996; and
- on the Futures Exchange, total annual trading volume, as measured by the number of futures and option contracts traded, increased to 8,081,880 contracts in 1997 from 5,945,320 contracts in 1996 (an approximately 35.9 per cent. increase) reflecting the increased activity on the Stock Exchange. In 1998, notwithstanding the lower trading

FINANCIAL INFORMATION

volumes on the Stock Exchange, total annual trading volume on the Futures Exchange reached a historical high of 8,489,642 contracts because of the increased volatility on the Stock Exchange. With the Hong Kong economy in recession and no exceptional news to affect the markets, total annual trading volume fell to a more "normal" 6,331,400 contracts in 1999, a decrease of approximately 25.4 per cent. compared with 1998, but still approximately 6.5 per cent. higher than the total annual trading volume in 1996. The effect of the extreme volatility on the Futures Exchange in 1998 during the Government's defence of the currency link can also be seen in the daily average amount of margin held by HKCC which stood at HK\$6.7 billion in 1997, increased dramatically to HK\$10.7 billion in 1998 (an approximately 58.7 per cent. increase) before falling back to HK\$5.6 billion in 1999, a decrease of approximately 47.2 per cent., but still approximately 35.1 per cent. higher than the equivalent figure in 1996.

As a result of the exceptional trading volumes on the Stock Exchange in 1997 the Group recorded total revenues of approximately HK\$2,825 million, and profits after taxation of approximately HK\$1,352 million, for that year. However, in 1998 the full effects of the economic crisis were felt in the depressed trading volumes on the Stock Exchange (although still higher than 1995 and 1996 volumes). Nevertheless, the volatility in the markets resulted in exceptionally high interest income for the Futures Exchange. Consequently total revenues for the Group fell to approximately HK\$2,480 million, while profit after taxation was approximately HK\$625 million. In 1999, with Hong Kong fully in the grips of an economic recession, total revenues were approximately HK\$1,999 million while profit after taxation was approximately HK\$521 million.

The results of the Group for the three years ended 31st December, 1999 must therefore be read in the context of these exceptional events.

A more detailed discussion of the results of the Group for the three years ended 31st December, 1999 is set out below.

Combined results of operations

Year ended 31st December, 1999 compared with year ended 31st December, 1998

The Group's total revenue in 1999 decreased by approximately 19.4 per cent. to approximately HK\$1,999 million (1998: HK\$2,480 million). The decrease was primarily attributable to a decrease in trading volumes on the Futures Exchange and in the amount of margin funds held as the exceptional volatility in the markets arising from the economic crisis and the Government's defence of the currency link in 1998 was absent in 1999. Trading fees from derivatives contracts traded on the Futures Exchange fell by approximately 20.9 per cent. to approximately HK\$113 million (1998: HK\$143 million). More significantly, the Group's interest income decreased by approximately 37.5 per cent. to approximately HK\$658 million (1998: HK\$1,052 million) (interest income on margin funds was approximately HK\$341 million (1998: HK\$695 million), representing a decrease of approximately 50.9 per cent.) as the daily average amount of margin held by HKCC fell to HK\$5.6 billion (1998: HK\$10.7 billion), and interest rates returned to more normal levels.

FINANCIAL INFORMATION

On the other hand, trading volume on the Stock Exchange rebounded from the conditions in 1998 posting an approximately 12.6 per cent. increase in dollar trading volume to approximately HK\$1,916 billion (1998: HK\$1,701 billion). Trading fees earned on securities traded on the Stock Exchange increased by approximately 19.7 per cent. to approximately HK\$314 million (1998: HK\$263 million). However, clearing and settlement fees for Stock Exchange trades recorded only a 0.3 per cent. increase as the increased fees resulting from the increase in trading volume on the Stock Exchange were offset by an approximately 17.6 per cent. reduction in the CCASS clearing and settlement fees charged by HKSCC. Similarly, a reduction in registration and transfer fees of over 22 per cent. by HKSCC together with a decrease in stock withdrawals from CCASS resulted in revenues from depository, custody and nominee services decreasing by approximately 41.9 per cent. to approximately HK\$144 million (1998: HK\$247 million).

Income from listing fees increased by 4.6 per cent. to approximately HK\$206 million (1998: HK\$197 million) due primarily to the listing of an additional 21 companies on the Stock Exchange's main board and the launch of, and listing of seven companies on, GEM in the last quarter of 1999. Income from the provision of information fell by approximately 7.1 per cent. as information subscribers did not renew subscriptions as a result of lower levels of activity in the markets.

The Group's total expenses in 1999 decreased by approximately 20.2 per cent. to approximately HK\$1,442 million (1998: HK\$1,808 million). This decrease was primarily due to (i) a significant 52.0 per cent. decrease in interest expense (approximately HK\$190 million) as the exceptionally high amount of margin funds held in 1998 was not repeated in 1999, and (ii) an approximately 94.5 per cent. decrease (approximately HK\$224 million) in the special contribution made by the Group to the Compensation Fund. However, the Futures Exchange Group lowered its retention rate to 1.2 per cent. in 1999 resulting in higher interest payments being made to HKCC Participants. Depreciation also decreased by approximately 10.7 per cent. to approximately HK\$150 million (1998: HK\$168 million) as the book costs of CCASS were fully depreciated in 1998 and no such expense was needed in 1999. The reduction in depreciation expenses for CCASS were, however, partially offset by additional depreciation expenses resulting from the acquisition and development of various computer systems by the Stock Exchange including upgrading TOPS and upgrading the existing trading technology and infrastructure to accommodate the trading of fixed income products and trading on GEM. Staff costs increased slightly by approximately 1.3 per cent. to approximately HK\$528 million (1998: HK\$522 million) due mainly to an increase in the number of staff at the Futures Exchange. Maintenance and network expenses increased by approximately 11.0 per cent. to approximately HK\$135 million (1998: HK\$121 million). This increase was mainly due to the installation of a dedicated e-mail system between the Stock Exchange and Stock Exchange Participants in 1999, additional rental of market datafeed hardware for stock information dissemination services and Y2K compliance projects.

Expenses in 1999 were also affected by the expensing of non-recurring legal and financial advisory expenditures of approximately HK\$61 million relating to the merger of the Exchanges and Clearing Houses under HKEx.

Taxation expenses decreased by approximately 22.4 per cent. to approximately HK\$36 million (1998: HK\$47 million) due primarily to the decrease in profits earned by the Group and a refund of 10 per cent. of 1997/98 profits tax charged to members of the Group totalling approximately HK\$13 million.

FINANCIAL INFORMATION

As a result of the foregoing, the Group recorded net profit after taxation of approximately HK\$521 million (1998: HK\$625 million), a decrease of approximately 16.7 per cent.

Year ended 31st December, 1998 compared with year ended 31st December, 1997

The Group's total revenue in 1998 decreased by approximately 12.2 per cent. to approximately HK\$2,480 million (1997: HK\$2,825 million). This decrease was primarily attributable to a more than 55 per cent. decrease in trading volumes on the Stock Exchange as the positive investor sentiment in 1997, which fuelled historical trading highs, was replaced by negative sentiment in 1998 following the onset of the economic crisis and speculative activities surrounding the currency link between the Hong Kong dollar and US dollar.

Trading fees earned on securities traded on the Stock Exchange fell by approximately 55.5 per cent. to approximately HK\$263 million (1997: HK\$591 million). Clearing and settlement fees for such trades fell by approximately 65.5 per cent. to approximately HK\$191 million (1997: HK\$555 million) as a result of the approximately 55.1 per cent. decrease in Stock Exchange trading volume and an approximately 44.9 per cent. reduction in the clearing and settlement fee charged by HKSCC.

Income from depository, custody and nominee services fees decreased by approximately 5.1 per cent. to approximately HK\$247 million (1997: HK\$261 million) as a result of a 15 per cent. reduction in the CCASS registration and transfer fee which was partially offset by an increase in stock withdrawal fees triggered by certain broker defaults at the beginning of 1998.

Listing fee income decreased by approximately 10.5 per cent. to approximately HK\$197 million (1997: HK\$220 million) as the number of new listings decreased significantly (32 companies, 21 debt securities and 157 derivative warrants in 1998 versus 82 companies, 61 debt securities and 351 derivative warrants in 1997) following a slowdown in capital formation activities in the primary market. The decrease in listing fees was partially offset by a 10 per cent. increase in the annual listing fee introduced in 1998.

In contrast to the Stock Exchange, the Futures Exchange had an exceptionally good year in 1998 as trading volume reached a historical high of 8,489,642 contracts (1997: 8,081,880 contracts) and the high volatility in the markets resulted in a daily average amount of margin held of HK\$10.7 billion (1997: HK\$6.7 billion). As a result of the foregoing factors, the increased surplus cash held by the Group following the stock market boom in 1997 and the abnormally high bank deposit rate for Hong Kong dollars prevailing from time to time in 1998 due to the attack on, and defence of, the currency link between the Hong Kong dollar and US dollar, interest income increased by approximately 60.9 per cent. to approximately HK\$1,052 million (1997: HK\$654 million). Interest income of approximately HK\$695 million was earned on the margin funds held, accounting for approximately 66.1 per cent. of total interest income, and interest income in turn accounted for approximately 42.4 per cent. of the Group's total revenues (1997: 23.1 per cent.).

Income from the provision of information increased by approximately 29.0 per cent. to approximately HK\$247 million (1997: HK\$191 million). This was due to the approximately six months time lag between the fall in turnover on the Stock Exchange and the consequential fall in demand for stock information as subscribers had been signed to non-cancellable subscription contracts for a minimum of six months.

FINANCIAL INFORMATION

Other revenue also decreased as the income received from a former clearing house fell to HK\$675,000 (1997: HK\$76 million). Such income represents payment to HKCC of surplus funds remaining following repayment of the Lifeboat Fund.

The Group's total expenses in 1998 increased by approximately 41.2 per cent. to approximately HK\$1,808 million (1997: HK\$1,280 million). This increase was primarily due to increases in interest expense, maintenance and network expenses and staff costs. The Group also expensed total contributions to the Compensation Fund of approximately HK\$237 million in respect of the total commitment of HK\$300 million to that fund agreed to be made by the Group as referred to in the section of this document headed "Business — business of the Group". This was partly offset by the HK\$87 million of income recorded up to 1998 from surpluses from the Lifeboat Fund. The approximately HK\$237 million in contributions to the Compensation Fund expensed accounted for 44.9 per cent. of the increase in the Group's expenses in 1998.

Interest expense increased by approximately 59.2 per cent. to approximately HK\$364 million (1997: HK\$229 million). This increase was principally due to the increase in the size of the average daily amount of margin held and to the reduction in the retention rate from 2.0 per cent. to 1.8 per cent. during the last six months of the year.

Maintenance and network expenses increased by approximately 31.0 per cent. to approximately HK\$121 million (1997: HK\$93 million) as a result of increased spending on hardware and software to increase the capacity of the Stock Exchange's trading systems and upgrade the central processing unit of HKSCC to cope with higher trading volumes, and an increase in telecommunication line rental expense for Stock Exchange third trading terminals located at broker offices.

Staff costs rose by approximately 9.5 per cent. to approximately HK\$522 million (1997: HK\$476 million) due to salary increases, and to the hiring of new staff by the Futures Exchange Group as part of an organisational restructuring and by the HKSCC Group because of the launch of the CCASS Investor Account Service in May, 1998.

Depreciation expenses decreased by approximately 10.7 per cent. to approximately HK\$168 million (1997: HK\$188 million) as a result of the book costs of CCASS becoming fully depreciated on 30th June, 1998 and new equipment for systems being developed not reaching the operational (and hence depreciable) stage in 1998.

Taxation decreased by approximately 75.6 per cent. to approximately HK\$47 million (1997: HK\$193 million) due to the decrease in the Group's profit before tax. Taxation expenses were further reduced by the exemption from profits tax of bank interest income earned by non-bank corporations which came into effect on 22nd June, 1998.

As a result of the foregoing, the Group recorded net profit after taxation of approximately HK\$625 million (1997: HK\$1,352 million), a decrease of approximately 53.8 per cent.

FINANCIAL INFORMATION

BUDGET GUIDELINES

As the Stock Exchange receives a portion of the transaction levy, it is required to comply with the budgetary guidelines laid down by the Financial Secretary in 1991, and revised in May, 1996 and April, 1998. These guidelines provide that:

- (a) no less than one-third of the Stock Exchange's budgeted expenses will be funded by income other than transaction levy and listing fees;
- (b) no less than two-thirds of the Stock Exchange's budgeted expenses will be devoted to fulfilling its functions as a self-regulatory body and to market development;
- (c) if spending on each of staff costs, other charges and capital account items exceeds 10 per cent. of budgeted amounts, the overspending will have to be reported to the Financial Secretary, and if the overspending will exceed 20 per cent., it will require his prior approval;
- (d) the excess of transaction levy over one-third of budgeted recurrent expenses will be transferred to the Development Reserve forming part of the Stock Exchange's general cash reserve and usage of the Development Reserve would be subject to the approval of the Financial Secretary; and
- (e) notwithstanding guideline (d) above, one-seventh of the Stock Exchange's income from transaction levy, less any applicable profits tax, is required to be allocated to the Development Reserve of the Stock Exchange (this guideline ceased to apply from 12th June, 2000, the date on which the Stock Exchange's share of transaction levy was reduced to 0.005 per cent.).

The Stock Exchange has never breached any of the budgetary guidelines.

HKEx is currently in discussions with the Financial Services Bureau of the Government and the SFC regarding possible amendments to relax the budgetary guidelines.

EARNINGS PER SHARE

Assuming the current Group structure had been in existence on 31st December, 1999 and accordingly that 1,040,664,846 Shares would have been in existence, and based on the Group's combined profit after taxation for the financial year ended 31st December, 1999 prepared on the bases set out in Appendix I to this document, the Group would have had historical earnings per Share of HK\$0.50. However, the Accountants' Report set out in Appendix I to this document does not contain a calculation of earnings per Share as PricewaterhouseCoopers considers the earnings per Share information to be hypothetical due to the reorganisation and preparation of the results of the Group on a combined basis.

FINANCIAL INFORMATION

DIVIDENDS AND WORKING CAPITAL

Dividends

HKEx is a newly formed company and has never paid any dividends. Prior to completion of their merger under HKEx, the main operating companies of the Group, namely the Exchanges and HKSCC, had never paid any dividends because they were prohibited by their respective constitutions (in the case of the Stock Exchange and HKSCC from their incorporation, and in the case of the Futures Exchange with effect from 9th May, 1989).

The Directors have adopted a dividend policy of providing shareholders with regular dividends within the constraints of the Group's earnings having regard to:

- the future capital requirements of the Group and capital efficiency;
- the need to retain capital to support the Group's stability and growth, including reserves required to be retained for prudent risk management purposes in respect of the Clearing Houses;
- prevailing and projected profitability;
- prevailing market dividend yields; and
- projected operating cash flow and the extent to which this will be sufficient to meet projected capital expenditure. In particular, the Directors will place importance on the Group's ability to finance the maintenance and development of its information technology hardware and systems as these underpin the Group's businesses and competitive position.

The level of total reserves of the Group as at 31st December, 1999, and the portion of these which are non-distributable, are set out in note 4(q)(iii) to the Accountants' Report in Appendix I to this document. The non-distributable reserves are reviewed from time to time and may have to be increased because of, among other reasons, the need for the Group to maintain reserves for prudent risk management in respect of the businesses of the Clearing Houses. Accordingly the balance of the Group's reserves may not all be available for distribution.

Working capital

The Directors are of the opinion that, after taking into account the Group's internally generated funds and banking facilities which are presently available to the Group, the Group has sufficient working capital to satisfy its present requirements.

DISTRIBUTABLE RESERVES

As at 31st December, 1999, the Company had no reserves available for distribution to the shareholders as the Company was incorporated on 8th July, 1999 and had an accumulated loss of HK\$12.5 million as at 31st December, 1999.

FINANCIAL INFORMATION

ADJUSTED NET ASSETS

The following statement of adjusted net assets of the Group is based on the combined net assets of the Group as at 31st December, 1999, as shown in the accountants' report set out in Appendix I to this document, and adjusted as described below:

	<i>HK\$'000</i>
Combined net assets of the Group as at 31st December, 1999 as set out in the accountants' report in Appendix I to this document	4,223,974
Revaluation deficit of properties held as fixed assets as at 31st March, 2000 (<i>Note 1</i>)	<u>(71,984)</u>
Adjusted net assets	<u>4,151,990</u>
Adjusted net asset value per Share (<i>Note 2</i>)	<u>HK\$3.99</u>

Note:

(1) Revaluation on properties

(i) *Revaluation of properties held as fixed assets*

This represents the deficit between the carrying value of the properties held as fixed assets (properties held for the Group's own use) as at 31st December, 1999 and the revaluation performed by an independent valuer as at 31st March, 2000. The carrying value of these properties is the net book value stated in the accountants' report as at 31st December, 1999 which represents the valuation performed in 1993 and 1995 less the respective accumulated depreciation.

(ii) *Revaluation of property held as investment property*

The audited combined net assets of the Group as at 31st December, 1999 is after taking account of the deficit arising from revaluation of the investment property (the property held for rental purposes) of the Group by an independent valuer at that date. According to the valuation report of the same valuer as at 31st March, 2000, there is no additional surplus or deficit arising from this valuation, details of which have been included in Appendix II to this document.

(2) Based on the 1,040,664,846 Shares that would have been in issue had the current Group structure been in existence on 31st December, 1999.

NO MATERIAL CHANGE

Save as disclosed in this document, the Directors confirm that there has been no material adverse change in the financial or trading position or prospects of the Group since 31st December, 1999, being the date to which the latest audited combined accounts of the Group were made up.