

**HKIAAT Accounting and  
Business Management Case  
Competition  
2008- 2009  
Secondary School Group**

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# Research on MTR's Past Performance and Suggestion of New Business

## Policies for Sustaining Its Growth and Performance

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### Intoduction

In year 2007, the MTR undergoes abrupt structural changes with the integration of 2 railway networks. New opportunities and challenges come to the MTR. Only through careful study on its past performances and the market environment can the company grab the right time to proceed. Therefore, we have attempted to carry out a research project and it is hoped that our results can guide a wiser production planning.

### Section A: The social responsibilities of listed companies in Hong Kong

1. Maximizing shareholders' profits should not be the sole goal of business operation.

Even though profit can be an important indicator of success, the benefits and the well-beings of the stakeholders should as well be considered when business goals are to be determined. This is because companies should have certain kinds of social

responsibility and, more importantly, back to the basic, it is the stakeholders who sustain and ensure the corporation's future development.

By saying stakeholders, we are referring to those people or groups that affect or can be affected by an organization's actions, including the employees, customers and suppliers, the general public and the government.

Beginning with the employees, it should be noted that the overall productivity and morale among the employees will directly affect the quality of the services provided. The working conditions and benefits enjoyed by the existing employees may serve as major considerations for potential talents.

As a result, ensuring smooth internal coordination that safeguards the rights of its employees should be a fundamental operating goal. Sharing the company's success with their employees via bonuses and welfare allowances help build a sense of belonging and thus booster working incentives. Training and entertaining functions should also be initiated, with the former one particularly essential during times of abrupt market or structural changes, so as to ensure competency among staff.

Being the direct consumers of the services, customers' responses determine how well the company can make profits, and thus their needs should be considered wisely. Customers normally have their own expectations for products, after sale services and prices and only through fulfilling these requests can a company gain good reputation

among its competitors.

Just like customers, suppliers as well play a key role in ensuring future success of the business through constant supply of raw materials and supportive services. Good relations should be maintained in between and companies should maintain good creditability through on-time repayments.

The government and the general public appear to be the most indirect, but indeed key stakeholders of companies. It is the company's social responsibility and interest to comply with the needs of these parties. In responds to the government, companies should view repaying taxes and compliance with law as essential objectives and this makes room for the company's future development. When considering the public, the company should take its initiative to cater for their needs of them in terms of the environmental standard and other social aspects.

**2(i).** Sustainable development stresses balances to be maintained in the three areas comprising the economy, the environment and the society(EES). This principal is to ensure that current prosperity and development would not trench the rights of our next generations in utilizing the same resources to foster progress.

Being a major player among Asian corporations and rail companies in the world, it is important for the MTR to uphold the concept of sustainability. To begin with, embedding sustainability and corporate social responsibility can create value for

stakeholders. The effort paid in striking progress not only in the economic area but also for social harmony and environmental protection would help the company to win over public appraisal and gain a positive reputation.

Besides gaining the intangible assets like goodwill and reputation, promotion of business can be enhanced with the concept held. In the narrow sense, attempts aiming at minimizing damage done to the environment and the society would promote a long-term cost- saving. As a rail company, MTR is one of the largest electricity users in the Pearl River Delta. Great benefits can be contained indeed through taking in sustainable competitive advantage; for example, the MTR successfully cut electricity and water consumption in the financial year 2006-2007, further enhancing its competitiveness through efficient resources utilization.

In a broader sense, sustainable development enriches the company with ability to manage related risks and seize associated opportunities. The abandonment of short-sighted progress for long term innovation helps the company to cope with the global trend towards environmental and social harmony, thereby minimizing the cost for possible adjustment due to market changes in the future.

**2(ii).** If I am one of the stakeholders of the MTR, I would definitely welcome a preparation of a sustainability report prepared. Given that it is not compulsory for a company to prepare it, MTR's attempt clearly reveals its determination in fulfilling its

social obligation as a key player of the domestic transit system. Via its sustainability report, one could easily weigh how well it has been doing in particularly the area ER, and get a boarder picture on the company’s future development and project direction.

Say I am one of the customers of MTR, via its sustainability report, I can be acknowledged of how well the company is doing to improve itself in delivering safe and reliable transport services. This certainly helps me in determining whether to continue taking the transport or not in the future. Analyzing the use of cost-effective production methods will as well provide me with a clearer map on possible discounts and changes in fares in the future.

Or say I am one of the employees or potential investors of the company, I will be pleased to see a sustainability report as I would see how well-prepared the company is in for the ever-changing environmental, social and economical circumstances. I can thus make a better decision on possible promotion prospect and opportunities in the company..

**Section B: Analysis of MTR’s historical data**

1.	Railway Operations and Related Activities		Property Development	
	2007	2006	2007	2006
Return on assets (%)	2.9%	3.0%	47.4%	43.8%
Assets / Total assets (%)	86.4%	86.5%	11.3%	11.0%

The high return on assets from property development came from large profit and relatively small amount of assets. The large profit (\$8304 million) was mainly due to

the change in fair value of properties (\$8011 million). The property rental and management income was only \$1749 million, while the income from railway operations and related activities was \$8856 million. This denotes that the revenue of MTR is mainly from the railway operations and related activities.

Besides, the percentage of assets over total assets for property development was only 11.3% while that for railway operations and related activities was 86.4%. The MTR invests more money on railway operations than property development as the company's principal activity is to operate an integrated railway network. In conjunction with the railway business, the company also engages in the property development.

In conclusion, the classification of MTR as a public utility company is correct.

## **2. (i) Ratio Analysis Report**

**Profitability:** The MTR has a fairly high net profit margin of 142.0%, as compared with a local listed company's 29%. This suggests that MTR was more efficient in controlling cost. However, its ROCE of 9.75%, is slightly smaller than that of the local listed company's 12.5%. It is because the MTR employed plenty of capital into businesses, like the Rail Merger. For the Rail Merger, the company obtained a new loan financing facility of HK\$10 billion and incurred deferred expenditure of HK\$492 million in connection with the acquisition of the respective assets. In terms of profitability, MTR is better than the comparable local listed company.

**Liquidity and debt management:** The current ratios of 0.7:1 for MTR and 1.8:1 for

the comparable local listed company indicate that MTR may not be able to meet the current liabilities when due, but the listed company is able to do so. The interest cover of MTR is 9 times while that of the listed company is 12 times. Although MTR's profits are still sufficient to cover interest payments, with the lower level of interest cover, there is greater risk to MTR's lenders that interest payments will not be met.

Furthermore, the total debt to equity of 71% for MTR and 28.4% for the local listed company suggest that both of them are solvent. But MTR has a much higher rate of total debt to equity. It is difficult for MTR to obtain further financing from banks and other lenders. It also has a heavy burden of interest expense. In short, MTR has liquidity risk and the local listed company has better liquidity and debt management.

**Asset management:** MTR and the comparable local listed company have the same debtors ratio of 75 days. It implies that they have the same efficiency in collecting debts, despite MTR's weaker liquidity position. Their fixed assets turnover rates are 0.08. They get the same ability to utilize their assets to generate sales.

**Investment appraisal:** The earnings per share for MTR is \$2.72. Together with the high PE ratio of MTR, 8.3 times, investors have strong confidence in the company, therefore they are willing to pay a higher price. On the other hand, the lower earnings per share of \$2.59 and PE ratio of 3.26 times for the listed company, implies lower confidence. However, they have the same dividend cover of 6 times. They have the

same ability to pay dividends. Also, the high dividend cover indicates that only a small amount of profits has been distributed as dividends and a large amount of profits has been retained as reserves which help to finance the operation of both companies.

## 2(b), SWOT Analysis Report

Area of concern	Descriptions
Strengths	➤ Financial strength with high net profit margin
	➤ Efficient cost control
	➤ Established as a market leader
	➤ Extensive diversification of operating activities
	➤ Having sufficient resources to operate in the foreseeable future
Weaknesses	➤ Poor liquidity position
	➤ Credit control needs to be improved
	➤ Not efficient assets management
Opportunities	➤ Expansion of renewable portfolio
	➤ Development in both local and international markets
Threats	➤ Economic downturn

**3(i).** Synergy is the term describing a situation where the final outcome of a system is greater than the sum of individual parts. For corporate synergy, a financial benefit is expected to realize when a corporation merges with or acquires another corporation.

**3(ii).** There are numerous synergy effects of the merger between the MTR and the Kowloon-Canton Railway Corporation.

1) The Rail Merger brought a significant increase in market share and patronage.

After the Rail Merger, the overall share of the franchised public transport market

increased from 25.3% to 41.6%. This increased the total patronage on the Integrated

MTR System by 8.2% to HK\$ 948.3 million. With the expansion in size of the rail

business, the MTR Corporation becomes the market leader.

2) The Rail Merger enabled the MTR to increase recurrent profitability. There was an increase of total revenue for 2007 to HK\$10,690 million, 12.0% higher than 2006. The operating profit from railway and related businesses before depreciation and amortization also rose by 13.7% to HK\$5,912 million. It is estimated that the Rail Merger effect contributed approximately HK\$284 million to such operating profit.

3) Expenses associated with running a business can be reduced through a variety of sources. It can eliminate redundant facilities and induce more efficient use of support functions, such as accounting, marketing and administration.

4) The company can capture future growth opportunities from expansion of the system. The scale of the railway and rail related businesses have significantly increased. It brings about business opportunities for MTR in the form of Duty Free shops and freight transportation, and growth opportunities in form of new railway lines throughout Hong Kong and connecting to the mainland. This provides a platform for the sustainable development of Hong Kong's public transportation services.

5) The property development land bank and rental property portfolio are enhanced. The MTR will also act as the Government's agent for developing West Rail property.

6) The Rail Merger brings about a Fare Adjustment Mechanism which in the Board's views will bring predictability, objectivity and certainty to the future fare setting,

particularly, with the direct-drive element of the mechanism.

4. In 2007, the company had to raise \$10 billion. Among numerous ways, the MTR chose the syndicated loan offered by 19 banks over the world to raise this fund. The loan comprised a \$3 billion 3-year term loan facility and a \$7 billion 5-year revolving / term loan facility. For the \$7 billion 5-year revolving/term loan facility, the company can ask the banks to loan the money repaid to it during the 5 years. The MTR does not have to worry that the cash will not be sufficient for daily operations due to repayment of the loan. Hence, the liquidity of the MTR would not be affected.

Also, the MTR is one of the most extensive franchised public transport operators in Hong Kong. The company obtained the loan easily due to its strong financial position. Additionally, the loan is offered by 19 banks. The banks syndicated as a group to offer the loan. The inter-procedure and the cost of syndicate were taken and paid by the banks. Moreover, the interest of the loan is less than the general since the risk of the loan is shared by 19 banks. Time and money are saved. We believe that these are the main reasons for the MTR to choose the syndicated loan.

There are other methods to raise the fund like issuing rights issue, preference shares, ordinary shares and debentures, as well as obtaining loan from one bank.

For issuing rights issue and ordinary shares, the MTR would usually issue at a price much lower than the market price. If the ordinary shares were issued at market

price, it would be unattractive to investors. It will be difficult to raise the principal.

For issuing preference shares, the MTR would have to issue at a lower price than the market price. Dividend would have to be paid to the shareholders yearly even if profit was small or there was a loss and this duration is always long. Thus, this may result in a heavy financial burden over the company.

For these 3 methods, adoption of them will certainly lower the market price of the shares due to the increase in supply. It is unfair to existing shareholders, thus it would be strongly opposed by a majority of the current shareholders.

For issuing debentures, debentures are issued at discount generally. The MTR has to redeem the debentures at nominal value. It is hard to raise fund if the interest rate is low. Hence, the cost of financing will be pretty high.

For issuing debentures and preference shares, the interest rate and loan tenor cannot be bargained even though the amount to be raised is very large due to the huge number of investors. Compared with syndicated loan, the loan tenor and the interest rate could be bargained to be the most beneficial level possible.

For obtaining loan from a single bank, it is hard to practice in Hong Kong. The reason is that Hong Kong banks are not allowed to loan more than certain percentage of their assets to a company or a group. \$10 billion is a vastly large amount of money. Therefore, some banks cannot loan to the MTR. Furthermore, the risk of the loan

withstood will not be shared by other banks. Hence, the interest rate and the loan tenor cannot be argued to the most beneficial level because of the high risk.

To conclude, the syndicated loan is the most appropriate way to raise the \$10 billion since the least amount of money and time is required.

The MTR's director intended to raise a further \$4 billion. The operating profit is thus believed to increase by \$320 million yearly in the foreseeable future. According to the directors, there are 3 ways to raise the further \$4 billion:

a. issuing rights; b. issuing preference shares; c. issuing debentures.

**For (a) (a rights issue of ordinary shares at \$4.5 each):**

Its issue price is the lowest among 3 choices and far lower than the market value. There is no doubt that it is very attractive to the investors. It is easy to raise \$4 billion. However, the increase in number of ordinary shares is giant. As a result, the market price of the ordinary shares will fall significantly due to the extensive increase in supply of the shares. Also, the profits have to be allocated to these new shares in the foreseeable future. Hence, earnings per share and dividend yield of the MTR will drop significantly and these ratio analyses will be below the general level. The attraction about high dividend of the MTR's ordinary shares will be weakened and the shares will be less competitive in the shares market.

**For (b) (issuing 4% preference shares with a nominal value of \$1 at \$5.2 each):**

The issue price of it is at the median among 3 choices. The issue price is still far lower than the market price although it is slightly higher than that of ordinary shares in (a). Therefore, it is still easy to raise \$4 billion. 4% of the interest has to be paid yearly. Nevertheless, it is not required to share profits to preference shareholders. According to the report, total dividend per share is about \$0.45 in 2007 and \$0.42 in 2006. If preference share is issued to raise the \$4 billion, the preference dividend per share is about \$0.04 only. It is obvious that the cost of financing by issuing preference shares will be much lower than that by the issue of ordinary shares. Furthermore, the issue of the preference shares will not affect the dividend yield and the earnings per share significantly since the preference dividend is not very large. It's about \$160 million yearly. The competitiveness of the company's ordinary shares can be maintained. Notwithstanding shares available in the market will increase significantly, the increase is smaller than that by issuing the ordinary shares as its issue price is higher. As a result, effects due to the increase in number of shares in the market will be smaller.

**For (c) (issuing 5% debentures with \$100 nominal value at \$90):**

The issue price is the highest among the 3 ways. Its nominal value is about 111.1% of its issue price. Also, the interest rate is quite high. It is higher than the fixed dividend rate in (b) and the general interest rate of deposit. Besides, the risk of holding debentures is smaller than that of holding shares. Under the strong financial

position of the MTR, no one will deny that the debenture is attractive and it is very easy to raise the \$4 billion. Additionally, effects over the shares are minimal. However, the cost of financing is the highest among the 3 options. First of all, its interest rate is higher than that of (b). Secondly, the MTR has to redeem them at 111.1% of the issue price. 11.1% of the debentures issue is about \$444.4 million. This cost is very high and this will result in a heavy burden to the MTR. Lastly, the MTR can use the fund for a few years only since the debentures have to be redeemed when they fall due.

To conclude, there are not significant problems in raising \$4 billion among 3 ways. It will be quite easy to achieve. By comparing the side-effects resulted, the cost of financing and effects by issuing preference shares is the most cost-effective way. Therefore, the most appropriate option should be (b).

**5.** According to the report, we are told that most of the MTR's business development expense is related to studies in mainland China and Europe, in line with the company's business strategy.

This expense is significant to the MTR. The reason is that the MTR would like to expand its structure in these years. Nevertheless, it could not do so even if it has sufficient fund. It is because the market in Hong Kong is almost saturated.

The markets in the Mainland and Eastern Europe are large and attractive. It is because transportation systems and infrastructure over there are not so advanced. It

is difficult to find railways or metros in these areas although they are developing rapidly. Railway and metros can help improving efficiency of the development. Thus, there is demand for railways. This reveals that the market of transportation system is very large over there. It is a great opportunity for the MTR to expand.

However, it is crucial to find where the best places for development are because plenty of money and lots of time will be invested in a new market. Choosing a wrong place for investment will result in wastage of time and money only. Furthermore, the daily operation would be affected because of insufficient current assets.

In short, the development expense can help the MTR to expand its structure in foreign market more effectively.

The ups and downs of the development expense will not affect daily operations of the MTR since the amount of the expense is not very large (\$268 million) compared with the total expenses of 2007(\$4778million). Certainly, it is not 100% that the MTR can find the most suitable and profitable place by spending more in development expense, but, the expense will be justified when a new market is located.

### **Section C: Business policies and method of performance evaluation**

1. After the rail merger, different challenges may be faced by the MTR in the foreseeable future. Various business policies can be adopted for its sustained growth.

#### **Product:**

To attract more potential customers, the MTR can improve its service quality and develop more new products. First, it can provide more subsidiary facilities along the MTR stations. For example, provide Wifi service to enable passengers and customers to use internet freely in the station. Besides, more exits can be placed to make it more convenient for the customers. Apart from stations, providing the shuttle bus services by linking the MTR stations with estates, shopping malls and sight-seeing spots etc.

With the increasing capital resources, the MTRC can expand its railway network to different areas. Refer to P.6 of the MTR annual report 2007, the company plans to expand several new lines, linking up Central and Sha Tin or even Guangzhou, Shenzhen and Hong Kong. They may also think of linking Hong Kong to Macau.

Apart from operating products, it can also improve its retailing services by cooperating with different large brand names or can use the train to facilitate celebration of birthdays. Last year, a wedding party was held inside the MTR train and it can also be used as a marketing strategy. Occasional renewal of the MTR station can also create a better image to the customers.

### **Marketing:**

The Company can lower fares and offer family ticket to attract more customers and provide inter-modal discount to other transport company. Since the number of customers decrease in the holiday, the family ticket idea can bring in more family to

travel. Small gifts such as watch, doll, etc. would also appeal to the customers.

Advertising can also attract more customers. Apart from the traditional advertisement, the company can use environmental conservation, sustainable development and social responsibility as a selling point to attract public attention.

They can also create a mascot to represent the MTR. It can be an animal or just a doll, like the five mascots in the Olympic Games.

### **Financial:**

Owing to the financial turmoil, banks are not willing to lend. To deal with financial problem, the company can sell their idle assets. After the merger, there could be more spare resources like raw material storage centre, they can sell it to earn money.

The company can rent out its property or build more property above the MTR stations like Harbor Green. Additionally, it can earn advertising income from various sources. For example, the company can try to cooperate with other companies like Cheung Kong (Holdings) Limited, to diversify its product. They can buy and sell their properties as an investment and develop buildings above the MTR stations.

When it is going to expand, it can issue bonds or shares to the public or ask the government (the biggest shareholder) to inject more capital to raise fund. The last resort would be to lower the dividend proposed to the ordinary shareholders as some negative effects on share price or public confidence to the MTR may be resulted.

## **Human Resources Management:**

With the merger and restructures, the employee of the company can have better career paths. Senior posts would have more job responsibilities and staff working under. Staff morale can be improved as they can compete for a higher post.

Training courses can improve productivity. At the same time, labor can become more skilful so the company can cut more labor to reduce cost. A uniform and well-rounded wage and welfare system should be developed after integration. For example, it can set awards to the outstanding staff or set bonus system, hence, the quality of the service can be improved.

Lastly, as there are more managerial and technical experts in the MTR after merger, they can be transferred to develop new railway lines. As it can fully utilize those idle labors; meanwhile, employment of extra labor for the expansion is not needed.

### **2(i).Performance indicators**

Apart from the income statement, we can observe the performance through the cash flow statement and balance sheet. The cash flow statement can tell the users about the movement and availability of cash in a company while the balance sheet can provide the data about the asset, liabilities and capital status in the MTR.

From the indicators stated above, we use different accounting ratio to show its financial situation and operating performance. The main ratios are stated as follow:

1. Liquidity ratio: ability of a business to meet its short-term liabilities
2. Profit margin: measurement of efficient cost control
3. Earning per shares: profit in dollars attributable to each ordinary share

Apart from the usual ratio analysis, we can use staff turnover rate to judge whether the company's operation is healthy. The fluctuation of the market price of a company's shares can also reflect the performance of a company as it is based on the expectation of the investors about the company.

Other indicators can be chosen such as customer survey. By asking customers about services they used, we can know more about the MTR's performance and what is there to improve. The investment or credit ratings can help assessing its credit worthiness of a company. Credit ratings, calculated by its financial history, current assets and liabilities, show the probability of the subject being able to pay back a loan.

## **2(ii).Indicators for the social responsibility**

For a franchised public transport operator, the MTR has the social responsibility in their operation. Some indicators can be used to measure their performance.

### **External:**

First, we can measure how much it has donated to charities based on the profit it earned and the charity work it has done.

Secondly, we can observe whether the development of the operator can fulfill the

purpose of sustainable development such as amount of pollutants produced, energy used and effect on the environment due to the extension of railway. The company's pricing can also reflect how well the company takes up social responsibility. If they lower fares for the elderly and the youngsters, it would show the company cares.

### **Internal:**

We can measure it by looking at the staff welfare and their working condition. The staff accident and complaint rate can show how the staff is being treated in a company. Also, the accident rate can measure the social responsibility of a company as it may show whether the service and the facilities are safe or not. We can see how much the company has done to minimize the accident like promotion work about the safety. Moreover, the delay frequency can act as an indicator since the operator is responsible to maintain the reliability of the rails especially in peak hours.

To conclude, the MTR should also consider the social responsibility to operate.

### **Conclusion**

Summing up our findings, it can be concluded that the merger undoubtedly brings the MTR with greater flexibility and more opportunities in further expansion. And, the past financial and social performances of the MTR were satisfactory. We sincerely hope that our research can guide a wiser production planning.

**\*\* End of Report \*\***