

## **Executive Summary**

On 2 December 2007, MTR stepped into a new era after its successful merger with KCR that it has become the largest franchised public transport company in Hong Kong. Being the market leader, MTR has to take a higher responsibility for various stakeholders including customers, employees and investors. So it is necessary for the company to review its whole latest business performance to prepare for the room for further expansion and challenges in order to maintain overall management efficiency as well as good business performance.

So the objective of this study is to review and analyse MTR's past performance and to suggest new business policies to sustain its future growth and performance.

The study started with the discussion on the social responsibility of MTR to its stakeholders and the significance of sustainable development to MTR. Then, a business analysis was carried out by looking closely at its business nature, financial ratios, strengths, weaknesses, opportunities and threats (SWOT). Moreover, the synergy effects of the company were illustrated as well as the matters concerning business development expenses such as the method of finance and its implications on the company's prospect. Last but not the least, recommendations as to business policies and performance indicator were made.

It is concluded that MTR should not ignore the stakeholders and continue to take a serious approach in achieving sustainability. For the business analysis, the company being a public utility of railway operations, its financial performance is satisfactory in comparing to its major competitor. However cautions should be taken as for its lower liquidity and financial stability. Furthermore, the company should ride on its advantages got from the Merger with KCR to continue its expansion plan in railway operations business in Hong Kong, China and overseas in order to increase recurring

revenue. If further money is required for expansion, preference share is appropriate under the current economic situation. In sourcing new recurring revenue, carrier service is recommended and MTRobot is designed to promote the product and image of the company. A more cautious approach should be taken for financial policy and measures are recommended to tackle the morale problem of the former KCR employees. Last but not the least, the performance indicator as to promote creativity and sourcing new revenue as well as contributing to educate the citizens are recommended. All the above policies and measures should be consistent with the company's culture of sustainability which is the key factor for the company's future success.

## **Research and Findings**

### **1 Social Responsibilities of Corporations**

#### 1.1 Corporate responsibilities to stakeholders

Increasing profits is undoubtedly the responsibility of a company. However, it's very dangerous if directors only consider maximizing shareholders' profits to be their sole operating goal. It is because a company's action will affect its many other stakeholders and more importantly, the company will be affected by them.

Take employees as an example, if the company cut staff cost in order to maximize its profits, this may lead to losses of morale and even experienced and knowledgeable employees. As a consequence, work efficiency and service quality deteriorate. It will erode the competitiveness of the company eventually. How about customers? If the company raises the fare to maximize profits, customers may shift to the competitors and thus affects adversely on the company's turnover. Let us look at the recent

example of HSBC. HSBC did not seek short-term profits by selling mini bonds to its customers. This gained the bank not only the ‘Brand-with-a-Conscience Award of the Year’ (SCMP, 7/11/08) but also the confidence of the public and thus long-term business in return.

In conclusion, the company cannot neglect the needs of other stakeholders but should act in an ethical and socially responsible manner, and have a positive attitude toward all stakeholders in order to gain sustainable profits.

## 1.2 Significance of sustainable development

Sustainable development is a pattern of resource use that aims to meet human needs while preserving the environment so that these needs can be met not only in the present, but in the indefinite future. Companies should shoulder the economic, social and environmental responsibility in building a sustainable future of the community ([http://en.wikipedia.org/wiki/Sustainable\\_development](http://en.wikipedia.org/wiki/Sustainable_development)).

For MTR, sustainable development is very important to its success because it is the guiding principle for the stewardship of the company. The company set out Six Sustainability Drivers to fulfill its responsibility in sustainable development to various stakeholders including: individual customers, employees, business partners and the whole communities in Hong Kong as well as the environment (<http://www.mtr.com.hk/eng/sustainability/2007rpt/index.html>). As sustainability becomes the major component of the company’s business culture, every level of the company works consistently towards this common mission that results in quality services to customers and a caring and responsible company to the community and the environment. This wins the hearts of the people and thus their great support to the company.

On the other hand, the public, being the biggest group of the stakeholders of MTR is happy to see a sustainability report because it discloses the company's important policies concerning sustainable development. Although these aspects, such as the future planning for networks expansion in the territory and the control of pollution, are influential to the public, they are not required to be published in the statutory reports. So the sustainability report raises the transparency of the company and allows the monitoring of the company by the public because it represents the company's pledge to the public. More importantly, preparation of sustainability reports will also lead to competition for good practice among its competitors and thus enhances the service quality to the public in general. So, sustainability report should absolutely be welcomed.

## 2 Business Analysis

### 2.1 Major business of MTR

To classify the business nature of MTR, we should look at two important indicators, i.e. the proportion of the assets for the business to that of the whole company and its returns. The table below shows that although the returns on assets for the business of railway operations in 2006 and 2007 were much lower than those of property development, the percentages of the respective assets to the total for railway operations over last two years were much higher than those of property development which accounted for over 86% of the total assets of the company.

	<b>Railway Operation and Related Activities</b>		<b>Property Development</b>	
	2007	2006	2007	2006
Return on	3,839/134,561	3,156/104,173	8,304/17,517	5,817/13,291

assets (%)	= 2.9%	= 3.0%	= 47.7%	= 43.8%
Asset/ Total	134,561/155,668	104,173/120,421	17,517/155,668	13,291/120,421
assets (%)	= <b>86.4%</b>	= <b>86.5%</b>	= 11.3%	= 11.0%

*Note: All data extracted from p.155 and p.157 of Annual Report 2007(AR).*

This heavy investment in railway operations evidenced that the importance of railway operations is greater than that of property development. In fact, MTR has long been running the Rail plus Property Model for which the income from property development is used to support the operation of the railway business. Which means railway operations is an indispensable part of MTR and thus MTR should be classified as a public utility of railway operations.

## 2.2 Ratio analysis

To analyze the performance and financial healthiness of MTR, the following ratio analysis has been conducted and the results are compared to a comparable local listed company ("K Ltd") as follows.

Ratio	MTR	"K Ltd"	Interpretation and limitations
<b>Profitability</b>			
Net profit margin	3,839/10,690 (AR p.157 and p.126) = <b>36%</b>	29%	MTR has much better operating performance than its competitor which is attributable to its better cost control and the benefits from the synergy effect after the merger.
ROCE	<b>18.10%</b> (AR p.21)	12.50%	MTR has higher ROCE means that it is superior in management efficiency and asset utilization. However, the accounting policies of these two companies may be different that hinder the

			accuracy of comparison.
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Ratio	MTR	“K Ltd”	Interpretation and limitations
<b>Liquidity and debt management</b>			
Current ratio	7,186/8,875 <i>(Note 1)</i>  <b>= 0.8:1</b>	1.8:1	MTR’s current ratio is only close to 1:1 which means that its financial risk of insufficient current assets to cover its current liabilities is high. So its liquidity is not as satisfactory as its competitor.
Interest cover	<b>9 times</b> <i>(AR p.21)</i>	12 times	MTR has a lower interest cover level than its competitor but the level is still acceptable.
Total debt to equity	<b>48.50%</b> <i>(AR p.21)</i>	28.40%	MTR has a high total debt to equity ratio which means that the company is highly geared in order to leverage the profit. However, the management should not be too aggressive because a highly geared company will results in fluctuations of profits. What’s more, off-balance sheet items e.g. the commitments as shown in Note 52 of Annual Report are not included in calculating the ratios so, the financial stability and liquidity of the company is even lower and caution should be taken on this.

Ratio	MTR	“K Ltd”	Interpretation and limitations
<b>Asset management</b>			
Debtors ratio (days)	1393/10690 (AR p.181 and p.126) <b>= 48 days</b>	75 days	MTR has better credit control than the comparable local listed company.
Fixed assets turnover	10,690/94,694 (Note 1) <b>= 0.11</b>	0.08	MTR’s ratio is slightly higher than its competitor, which also contributed to the company the better ROCE.
<b>Investment appraisal</b>			
Earning per share	<b>\$2.72</b> (AR p.126)	\$2.59	MTR’s EPS is slightly higher than its competitor and thus more attractive to investors.
PE ratio	22.6/2.72 (Note 2) <b>= 8.3 times</b>	3.26 times	MTR’s much higher PE represents the strong shareholders’ confidence on the company’s future. This is due to the company’s huge future expansion of transportation business in Hong Kong, China and overseas which is not available to the competitor.
Dividend cover	15,182/2,522 (AR p.126) <b>= 6 times</b>	6 times	MTR has the same dividend cover as the comparable local listed company. It implies that the company is in line with its competitor for dividend policy.

Note 1: See Appendix I for breakdowns of figures.

Note 2: Market price on 30 September 2008 was taken from

<http://hk.finance.yahoo.com/q/hp?s=0066.HK>

When we interpret the ratios of the company in assessing its performance and the financial status, we should also be aware of the limitations of financial performance assessment. Other factors like the economic atmosphere and business environment faced by the company and the related party transactions should be taken into consideration in formulating the conclusion (T/Dialogue, October 2008). Moreover, the data for ratios calculation are historical, financial information users should consider current economic situation or even estimate the future to make decision. For instance, under the current financial crisis, MTR possessing \$25 billion in foreign exchange forwards and interest-rate swaps as in October 2008 (SCMP 24/10/08) is exposed to huge currency risk and potential loss. These kinds of information should not be undermined as they are essential in decision making.

### 2.3 SWOT analysis

The major internal strengths and weaknesses of MTR as well as the opportunities available and threats imposed to the company from the external environment are summarized as follows.

#### 1) Strengths

- Strongest network, largest land banks and many other benefits from the synergy effects (to be discussed in section 2.4) as a result of the Merger further empower MTR to be the monopolistic market leader.
- Being backed up by its major shareholder, the government, MTR has adequate resources for its network expansion and future development plan.
- The Rail plus Property Model is specifically successful that property development business supports the railway operations as well as the returns to shareholders.

## 2) Weaknesses

- Being “Big” may hinder communications and undermine flexibility. With MTR promised to take all former KCR’s employees, they may be “too save to work hard”. All these results in inefficiency.
- In addition to the quarrels between the former KCR Chairman and its CEO in 2006, the Merger has brought much uncertainty to its employees and further drag down their morale.
- Over dependent on property development means that shareholders’ returns are vulnerable in times of economic recession.

## 3) Opportunities

- The China government has announced 4 trillion yuan stimulus package on November 9 aimed at boosting domestic demand over the next two years including 1.8 trillion yuan on railways, roads and airports (SCMP, 28/11/08). This represents potential railway network building and consultancy service business to MTR.
- Financial tsunami hard hit the economy and people, especially the middle class, tends to save transportation cost by taking MTR rather than driving or taking taxi.

## 4) Threats

- Monopolistic status of MTR will induce regulatory bodies, such as the Legislative Council and other pressure groups to monitor the company. That will definitely affect its operation or even profits.
- Under the financial crisis, economic activities slow down and the confidence of people collapsed. Consumption and investment decline drastically that MTR’s

income will undoubtedly be affected, especially for the property development business.

In conclusion, MTR should ride on its strengths to capture the business opportunities and eliminate its weaknesses in order to get rid of the threats.

#### 2.4 Synergy effects of the merger

Synergy can be simply implies as the meaning of whole is greater than the sum of its part. It means that the relationship, which the parts have to each other, is a part in and of itself. It is no only a part but the most catalytic, the most empowering, the most unifying and the most exciting part. Synergy is the essence of principle-centered leadership. It catalyzes, unifies, and unleashes the greatest powers within people.

Synergy effects of merger can be classified into four main aspects: 1) revenue enhancement, 2) cost reduction, 3) tax gains and 4) lower cost of capital. For MTR, the benefits from the synergy effects of the Merger mainly come from the first two.

##### 1) Revenue enhancement

Wider coverage after the Merger definitely enhanced MTR's revenue generating power from rail operations. Customers are encouraged to take MTR more because of the fare reductions as well as the easier interchange. For instance, despite the fact that there is no fare raise in the past ten years for Airport Express, the average fare has increased by 0.8% in 2007. This increase was attributable to the longer journey that customers have taken when they set off from stations along the East Rail/ West Rail lines. Other evidences include: the total revenue increased by 75.7% to HK\$8,527 million in the first half of 2007 as compared to the same period last year with total fare revenue increasing by 72.2% and the company's increase in the market

share in Hong Kong franchised public transport market to 41.6%, which is greater than the aggregate of the market shares of MTR and KCR as shown in the table below.

	Market share in the first half of 2007	Market Share in the first half of 2008
<b>MTR</b>	15.6%	<b>41.6%</b>
<b>KCR</b>	25.3%	
<b>Bus</b>	41.5%	40.1%
<b>Green Mini Bus</b>	14.4%	14.8%

The Merger also facilitated integration of stations for which increased the advertising and shop spaces as well as their popularities and has led to increases in advertising and rental revenue. For instance, station commercial revenue has increased by 4.8% and average rental reversion at shopping centers has increased by 22%.

Last but not the least, future revenue can also be enhanced with the merged corporation possesses greater resources so that its ability to bid for overseas projects becomes higher.

(All the figures above are taken from Annual Report 2007)

## 2) Cost reduction

A merged corporation can enjoy the economies of scale that results in increased efficiency and thus cost reduction. Cost reduction is possible for MTR with bulk buying of supplies and energy. Moreover, the duplicated functions or work of the company can be eliminated hence time and money can be saved.

In fact, the benefits from the synergy effects were reflected in the company's share price after the Merger - the share price increased from \$18.52 as at 30 June 2007 to

\$28.7 as at 31 December 2007 (Annual Report 2007). This represents a capital gain directly beneficial to the shareholders.

## 2.5 Finance of business development

In October 2007, MTR raised \$10 billion by syndicated loan successfully. Other forms of finance were not opted because of the following reasons. First of all, under the surging stock market last year, the 4% and 5% returns from preference shares and debentures were not attractive enough to investors. While for rights issue, the great discounts offered and the diluting effect would negatively impact on the share price of the company as shown in the recent example of Standard Chartered that its ordinary shares price decreased by 5.4% after announcement of its rights issue plan (SCMP 25/11/08). On the other hand, for the HKSAR government is the major shareholder of MTR, rights issue means the government has to put extra money to the company on top of the cash grants for its future network development. This budget approval takes time and is difficult to be passed by the Legislative Council. Likewise, the issue of preference shares and debentures are also time consuming and costly. So syndicated loan is the most promising and convenient way in raising such a huge amount of capital.

For raising the additional \$4 billion, we can choose from the three methods by comparing their opportunity cost, i.e. the dividend and interest to be paid.

	<b>Rights issue</b>	<b>Preference share</b>	<b>Debentures</b>
No. required to raise \$4 billion	\$4 billion/\$4.5 ( <i>Note</i> ) = 888,888,889	\$4 billion/\$5.2 = 769,230,769	\$4 billion/\$90 = 44,444,444
Opportunity Cost:	888,888,889*\$0.45	769,230,769*\$1*4%	44,444,444*\$100*5%

Dividend/ Interest	= \$400 million	= <b>\$30.8 million</b>	= \$222.2 million
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*Note: Dividend per share as at 31 December 2007 (Annual Report 2007, p.20) is taken assuming the dividend policy is the same as that for the existing ordinary share.*

As shown in the above table, issue of preference shares cost the least. In addition, preference shares carry no voting rights and can be redeemed by the company that it would not affect the voting rights and long-term profits of existing shareholders. For potential investors, \$5.2 is cheap and the 4% return is reasonable for this low risk investment and thus this issue is able to attract enough investors. So, issuing preference share is the most appropriate option in raising the \$4 billion.

## 2.6 Role of business development expenses in MTR's prospects

MTR's business development expenses relate mainly to the studies of the business opportunity in China and Europe. These expenses were significant that they accounted for 6% of the total operation expenses (Annual Report 2007 (Powerpoint Presentation)) and these expenses from 267 million in 2006 to 268 million in 2008 (Annual Report p.126 and p.127).

No matter railway operations or property development, the growths of these businesses in Hong Kong are constrained geographically. Even MTR continues to expand locally, the business capacity will be saturated one day and revenue cannot grow by then. Therefore, in order to ensure the future growth of business and profits, it's very important for MTR to explore different business opportunities overseas. Allocating large amount of financial resources for this purpose may affect the profits in the short-term, but these expenses will be paid back in the long-term. Actually, these development expenses have gained MTR business opportunities in Europe - the operating franchise for London Overground Rail Operations Ltd with Laing Rail and in China – projects in Beijing, Shenzhen, Wuhan, Hangzhou and Suzhou (Annual

Report 2007 (Powerpoint Presentation)). For the economic growth in China, even at worldwide economic hard time is estimated at 7.5% by the World Bank is still the highest globally. So MTR has invested wisely to capture these new sources of operating income and thus strengthen its operating prospects of the company.

### **3 Business Policies and Performance Evaluation**

#### **3.1 Business policies**

In planning the business policies in the time of global economic recession, the company should consider the needs and situations of the customers as well as the company under challenge and hardship.

##### 1) Product

Taking the advantage of wide railway network coverage of MTR, the company can extend its railway operation from carrying passengers to delivery of parcels, i.e. carrier service. In doing this, service counters will be set up at all MTR stations for parcels to be delivered or collected. The service fee depends on size of standard boxes, weight and the number of stations to be delivered but it should be lower than the existing carrier service in the market. Customers can simply drop or pick up their parcels in a station convenient to them. This is a win-win service that benefits both the customers and MTR. For customers, since service charge is low, it really helps small and medium sized enterprises (SME) to save money and ease their burden during the economic hard time. On the other hand, this can lessen the inconvenience caused by the carrier companies putting bulky parcels in the MTR car. Instead, a separate car in the train is assigned to transport the parcels during non-peak hours. Moreover, as many Internet bidders will arrange their transactions to be completed in the MTR station, this service can ease the crowdedness in the concourse area as the bidders

don't need to wait at the station. For MTRC, the company can assign existing staff to do the job so the cost of the service is low. With the increasing transactions of Internet trade and the current economic situation, this service will be popular and profitable.

## 2) Marketing

At this bitter time of economic hardship, MTR can take a more humorous approach to promote its image of caring. For this purpose, a cartoon character - MTRobot is designed (see Appendix II). This MTRobot is strong, high-tech and optimistic which acts as a key representative to convey one message: "MTR steps forward with you to face every challenge in life." Marketing promotion includes a series of thematic TV commercial and MTRobot puppets to give out souvenirs at the MTR stations and the company's shopping malls. The main theme of the promotion is to encourage the Hong Kong people to live an optimistic life. This will definitely boost the image of MTR for its care to the community.

## 3) Financial

Under the financial crisis, revenue from property development is expected to drop drastically. The existing low returns from railway operations (as shown in section 2.1) also mean that this business alone cannot provide adequate commercial returns to shareholders. Therefore MTR must explore new source of recurring revenue. So the company should continue to put resource on research and development to capture China and overseas railway construction projects and consultancy business to ensure growth of revenue.

Risk management is another key issue for MTR. CITIC huge loss from investments in structured financial products has taught a lesson for the companies in Hong Kong.

For MTR, holding \$25 billion foreign exchange forwards and interest-rate swaps has cost the company a 4.75% drop in share price on 23 October 2008 (SCMP, 24/10/08).

It's recommended that company should take a more conservative approach in its investment and be more cautious in asset protection.

#### 4) Human resources management

The Merger has brought much uncertainty to the KCR employees and their morale has been a problem for KCR. To tackle this problem, the following methods can be used:

- Employee ownership that links the performance of the company to the benefits and compensation to the employee.
- Information sharing to evade employees' uncertainties.
- Participation and empowerment to increase employees' job satisfactions.
- Team building to raise spirit of employees and to promote cooperation among them.

After the Merger, MTR is supposed to enjoy cost saving from synergy. This can be done by better coordination among employees and better job design. For instance, integration of administration work to reduce workload and thus spare rooms for service improvement and new business development. In this way, sustainable competitive advantage can be produced to the company.

### 3.2 Performance evaluation

The performance indicator is used to specify what is to be achieved and to enable evaluation and control based on outcomes. It can act as a tool to direct efforts of the management in achieving a particular strategic goal. For MTR, the existing problem is

that it depends too much on the return from property development which is not recurring and is highly fluctuating with the economic condition. So, the leading performance indicator of profit before tax is not satisfactory in motivating the management to put efforts in exploring new source of revenue, especially the recurring ones. So it is suggested that MTR can add a performance indicator that require business to maintain a certain percentage of revenue from new service/project to the total revenue of the business. This indicator can promote creativity in the company and direct the management efforts in sourcing new business opportunities. This can help the company with long-term revenue growth and thus is consistent with the company's mission of sustainability.

For the performance indicator concerning social responsibility, as MTR is the biggest franchised public transport operator in Hong Kong, it carries massive Hong Kong people everyday. So it is very influential to the community and the company can take its trains and stations as a channel of education in various aspects: from caring the disadvantaged, to manners of people and to environmental protection. In doing this, a performance indicator as maintaining a percentage of profits to spend on such education purposes is suggested. This indicator not only creates goodwill for the company but more importantly, make real contribution to the society.

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### **Appendix I – Breakdowns of figures to ratio analysis**

<b>Current Assets</b>	Reference	HK\$ m
Investments in securities	Notes the Accounts (Note) 29	50
Properties held for sale	AR p.127	756
Derivative financial assets (based on undiscounted cash flow)	AR p.177	109
Stores and spares	Note 33	347
Debtors, deposits and payments in advance (\$139 m represented amount to be recovered between one to three years)	AR p.182 Para 2	5,028
Cash and cash equivalents	AR p.127	576
Amounts due from the Government and other related parties	Note 36	317
Staff housing loans	Note 30	3
<b>Total</b>		<b>7,186</b>

<b>Current Liabilities</b>	Reference	HK\$ m
Bank overdrafts	AR p. 127	2
Short-term loans		507
Creditors, accrued charges and provisions		5412
Current taxation		3
Contract retention	Note 40	93
Amount due to related parties	AR p. 127	975
Loans and obligations under finance leases (due with 1 yr)	AR p. 185	1155
Derivative financial liabilities (Less than 1 year)	AR p.177	(22)
Obligations under Service Concession (repayable within 1 year)	Note 42	750
<b>Total</b>		<b>8875</b>

<b>Total Property, Plant and Equipment</b>	HK\$ m
Investment property	36,562
Other property, plant and equipment	79,444
Service concession assets	15,250
	<b>94,694</b>

Appendix II – MTRobot



MTRobot



MTRobot  
(Airport Edition)

