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(庫務科)



FINANCIAL SERVICES AND THE  
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(The Treasury Branch)

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8 April 2004

Clerk to Panel  
Panel on Transport  
Legislative Council  
Legislative Council Building  
8 Jackson Road  
Central, Hong Kong  
(Attn: Ms Alice Au)  
Fax: 2121 0420

Dear Miss Au,

**Panel on Transport  
Meeting on 27 February 2004  
Possible Merger of MTR Corporation Limited (MTRCL) and  
Kowloon-Canton Railway Corporation**

Thank you for your letter of 16 March 2004.

At the Panel meeting on 27 February 2004, Members requested the Administration to provide information on the findings of Government's internal assessment on the merger proposal (paragraph 37 of the draft minutes of meeting refers).

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Enclosed please find an abridged version of the report prepared by N. M. Rothschild & Sons (Hong Kong) Limited, which was engaged by the Government to advise on the feasibility of the merger proposal last year. Information that are price sensitive to MTRCL shares have been omitted. Please note that the report was prepared in 2003 on the basis of then available financial figures.

The report should not be treated as a recommendation to buy, sell or hold shares in MTRCL. It is not a research report on MTRCL shares nor should it be treated as an advice to the minority shareholders of MTRCL in relation to the merger proposal. Since the report contains information pertain to a listed company, grateful if you could make it available to the public at the same time when disclosing it to Members.

Yours sincerely,



( Tommy Yuen)  
for Secretary for Financial Services  
and the Treasury

c.c. SETW (Attn: Mr Patrick Ho)



# KCRC / MTRCL Merger Feasibility Study

Abridged version of report dated 12 August 2003: Issued March 2004

## Important notice

N M Rothschild & Sons (Hong Kong) Limited (“Rothschild”) was engaged by the Government of the Hong Kong Special Administrative Region (“HKSARG” or the “Government”) to provide independent advice on the feasibility of merging Kowloon-Canton Railway Corporation (“KCRC”) and MTR Corporation Limited (“MTRCL”) and/or their respective assets (“the Merger”). Our financial advice, under the terms of our engagement contract, was contained in a report to HKSARG dated 12 August 2003 (the “Report”). The information and analyses contained in, and opinions expressed in, the Report were based, among other things, upon confidential information provided to Rothschild by MTRCL and KCRC.

This document is an abridged version of the Report produced at the request of the Government. The information contained herein is accurate as at the date of issue of the Report and the Report has not been updated although, where it believes that it might be helpful to the reader, Rothschild has added footnotes on a selective rather than an exhaustive basis.

Given that the analysis underlying some elements of the report has been based on commercially and/or price sensitive information, certain paragraphs and tables containing or referring to commercially or price sensitive information have been omitted from this abridged version. Accordingly, this document does not and does not purport to contain all the information that may be necessary to fully evaluate the Merger. In addition, where certain paragraphs of the Report have been omitted, limited additional text has been added to facilitate maintaining the logic of the document for the reader. The section of the Report focusing on an implementation plan has been omitted from this abridged report as it will have been superseded by the passage of time and the plans put in place by HKSARG and the two railway corporations since the announcement of the intention to proceed with merger discussions.

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## Executive Summary

*Study addresses whether KCRC and MTRCL should merge, and if so, how*

This feasibility study addresses two critical questions in the context of a possible merger of KCRC and MTRCL: (a) whether Government should pursue a merger of the two corporations, and (b) if so, how they should be merged. In undertaking our work, we have also considered and concluded on the following issues:

- the indicative valuation of KCRC;
- the inter-relationship between regulation (in particular, modification to the fare setting arrangements currently under contemplation) and a potential merger;
- the financial parameters within which a merged railway company would operate, and their consequences for the appropriate mix of consideration payable to HKSARG; and
- the key steps necessary to implement a decision to proceed with a merger, should a decision be taken to proceed.

*We favour a merger – on the right terms*

Overall, our conclusion is that, subject to HKSARG being able to agree the right terms with MTRCL, there is likely to be benefit in proceeding with a merger of the two corporations. We believe that a merger would:

- maximise the potential proceeds available to HKSARG from the ownership of its railway assets in Hong Kong;
- afford scope for synergies and hence create incremental value which can be deployed to the benefit of the travelling public through fare reductions or generate incremental shareholder value, of which HKSARG will be the largest beneficiary;
- improve the equity market perception of MTRCL and its prospects, thereby further enhancing shareholder value. In particular, this would improve not only the likely proceeds from any future sell-down in HKSARG's shareholding interest in the merged company but also its achievability in the short term; and
- support the development of the railway as the backbone of the transport system in Hong Kong.

*Favour retention of MTRCL listing*

We believe that the optimal transaction structure is one in which MTRCL's listing is maintained, and where the merger consideration is a blend of cash and shares. The primary rationale is that (i) any structure which does not make use of MTRCL's existing listing removes an established, accessible route to the equity capital markets; (ii) a full merger between KCRC and MTRCL is most likely to achieve the greatest extent of synergies and, therefore, the greatest degree of benefit for shareholders and passengers; (iii) an element of share consideration for KCRC will be required in order to ensure that the

merged entity remains on a robust financial footing; and (iv) the payment of some cash by MTRCL to HKSARG within the consideration allows Government to realise some proceeds and to do so, potentially, earlier than any MTRCL 2 sale.

*Regulation in merger context*

On regulation, a merger provides an opportunity for HKSARG to seek to vary the current fare autonomy which the rail corporations currently enjoy. MTRCL's consent to such a change is necessary. Accordingly, the issue of merger and fare setting are closely linked. We do not believe that the merger significantly impacts on the competitive position of the two railways, although we recognise that, for wider policy reasons, there may be an imperative for greater control to be exerted over changes in fare levels.

*Timing*

Should a decision be taken to proceed with the merger, we believe that HKSARG can realistically aim for completion of the transaction in Q3 or Q4 2004<sup>1</sup>. Achievement of this timetable requires early preparation and, in particular, passage of the relevant legislation through Legco in the first half of 2004.

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<sup>1</sup> March 2004 comment: implementation now expected in 2005/6 if the required legislative process is completed next year

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## 1. Introduction

*Advice developed through iterative discussions*

Rothschild is pleased to submit its report on the feasibility of a proposed merger between MTRCL and KCRC<sup>2</sup>. Our recommendations contained in this report have been developed, as more fully described in Section 2, through a process of iteration with the relevant officials, firstly by examining the objectives of HKSARG in considering any potential merger, and secondly through discussing, refining and optimising our recommendations in the light of feedback received. The Draft Feasibility Report prepared by HKSARG covered the principal merger options and highlighted many of the arguments for and against. We have built on that report, used our discussion of governmental objectives and carried out analysis to propose outcomes, which we believe, match the needs of the whole of the Hong Kong SAR Government.

Railways are complex industries, blending engineering excellence and skills, business requirements and a vital social function. In particular, they move people along their networks which results in a more intense focus on quality and safety of operations than for other “utilities” - this makes railways unique among that class of companies, and the challenges of balancing investor requirements and social obligations are profound. This is a key feature of a potential KCRC / MTRCL merger with the need to balance, on the one hand, the investable business proposition and shareholder value with, on the other hand, the need for Government to facilitate fare reductions in a deflationary environment.

*Enaction of merger will require significant preparation*

The potential merger, if progressed, poses some significant challenges, one of which is defining a legislative framework in time to facilitate the realisation of some proceeds in fiscal year 2004/05<sup>3</sup>: whilst this may appear achievable, our implementation programme illustrates the near-term need for the enaction of a focused programme if the essential legislative framework is to be in place to meet the time scale envisioned.

We would like to record our appreciation for the openness and co-operation of both railway corporations during the conduct of our work.

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<sup>2</sup> March 2004 comment: Merger Feasibility Report was submitted on 12 August 2003

<sup>3</sup> March 2004 comment: merger now expected to generate proceeds in 2005/6



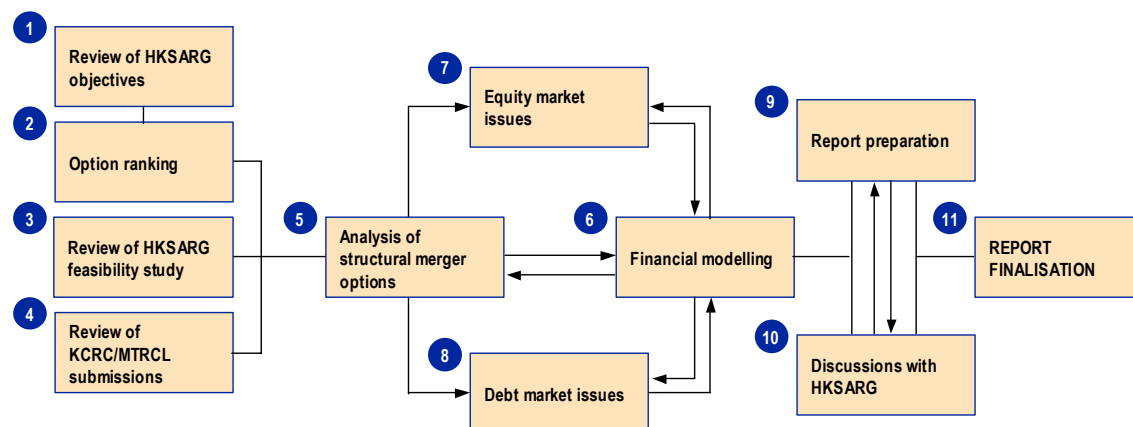
## 2. Approach to the assignment

### 2.1 Overall approach

*Have sought to gain clear understanding of HKSARG objectives*

In common with other governmental assignments internationally, our approach to the assignment incepted with discussions with key officials to gain a clear understanding of the various objectives of HKSARG in considering a merger between KCRC and MTRCL. It is natural that some of those objectives will be conflicting. Against that background, our process of review and analysis has been directed towards recommending outcomes which, in our view, match those objectives as fully as possible.

The diagram below represents schematically our approach to the assignment:



*Our work characterised by iterative methodology*

Our work has been characterised by an iterative methodology. Based on our preliminary assessment and understanding of HKSARG's objectives, we developed preliminary solutions and advice for discussion. We reviewed our initial solutions based on feedback provided by HKSARG during interactive discussions to formulate our final advice. This methodology has enabled us to take into consideration the views of different Government bureaux and departments, which we have reflected in our advice as documented in this report.

## 2.2 Definition of objectives

*Definition of objectives has been essential*

Governments have varying objectives for many courses of action driven by fiscal and wider social policies. It is therefore essential to define at the outset what the objectives of any process are and, to the extent possible, prioritise the objectives so that recommendations can be framed. Below we highlight some potential key objectives in relation to a merger which we have considered in our work and discussed with HKSARG:

### Financial

- Proceeds – maximise proceeds from any merger and to extract them as early as possible, consistent with other goals
- Value – maximise the aggregate value of the Government’s investment in the railway businesses, including the impact of synergies
- MTRCL equity story – given its majority shareholding in MTRCL, HKSARG has an interest in improving the listed company’s growth prospects and equity story to maximise the value of its shareholding (and proceeds from potential future sell-downs)
- Privatisation – demonstrate HKSARG’s commitment to its Asset Disposal Programme
- Minimise financial support – a merger should not give rise to increased financial support for future infrastructure projects

### Transactional

- Speed and simplicity – any transaction (and the structure chosen to facilitate such an exercise) should provide for a swift and simple execution process with low execution risk
- Retention of MTRCL listing – whilst the retention of MTRCL’s listing is not a goal in itself, retaining a listing in any merger would secure the Government’s continued access to equity capital
- Post-merger operational efficiency – any decision on merger should be predicated on enabling the seamless operational integration of the two corporations

*Continued over page*

**Transport / planning**

- Fare setting mechanism – a merger offers an opportunity to achieve a change, albeit within the confines of what MTRCL in particular will assent to
- Fare reductions – a merger may be an opportune time for HKSARG to achieve (at least partially) its transport policy in relation to rail fares
- Passenger interchange – enables the two corporations over time to create more convenient interchanges for the travelling public
- Rail as transport backbone – enhances the competitiveness of railway corporations

**Social / environmental**

- Minimise the extent of job reductions caused by any merger
- Environmental effects of bus competition – a stronger and more competitive railway should ease congestion and reduce pollution

*NB: order of objectives in tables above does not necessarily reflect order of HKSARG objectives or priorities between them*

We have discussed these parameters with relevant governmental officials, and were assured that the objectives summarised above were among those core objectives of Government.

*Some objectives inter-related or conflicting*

A primary role as financial adviser to HKSARG is to help Government to understand the balance between the Government's objectives and to advise on what we believe the optimal solution to be, seeking to achieve those objectives whilst being acceptable to the two businesses and the travelling public. In doing so, several key policy objectives have at the same time been weighed against one another, primarily in relation to synergies and fares. The implementation of fare cuts and any changes to the fare setting arrangements will, for example, diverge from the goal of proceeds and value maximisation. Allocation of such synergies is crucial for the transaction to be beneficial to all parties involved, and this process of allocation will be a key component of any merger negotiation.

## 2.3 Scope of work

*Have sought to deliver both independent and objective advice*

The process of defining objectives and refining our advice has been facilitated by a number of presentations. However, this report formally constitutes our financial advice<sup>4</sup>. There are a number of important caveats:

- We have relied on the financial and other information provided to us and we have not conducted detailed due diligence on that information: where we have made assumptions that go beyond the data provided to us, we have used assumptions which, in our view, are realistic and consistent with data received;
- Our indicative valuation represents a judgement as at the date of this report based on the information provided to us, our market perspectives and our financial modelling;
- We refer in this report to the realisation of proceeds from the sale of shares: all such comments are subject to prevailing market conditions and the nature of the equity story at the time at which a capital markets transaction is contemplated; and
- By way of comparison with a merger, we have considered briefly the issue of a KCRC IPO but this does not assume that such an IPO is or would be government policy, nor does this report constitute a feasibility study of such an IPO, or an assessment of the suitability of KCRC for listing or the achievability of such an IPO within a set timeframe. Such a feasibility study would be a separate exercise requiring detailed due diligence and management access.

Our work has been focused on advising expeditiously on the desirability and feasibility of a merger against the background of the objectives of HKSARG.

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<sup>4</sup> March 2004 comment: 12 August 2003 report constituted financial advice and only HKSARG may rely on that advice

## **2. Whether to merge?**

### **3.1 Introduction**

*Primary focus has been financial rationale*

The issues of whether to merge and how to merge are closely linked: it may be more beneficial to merge in one way rather than another. However, we have, for ease of analysis, decoupled these two issues. In relation to ‘whether to merge’, we have focused on the financial rationale behind a merger, supplemented by a review of the advantages and disadvantages in respect of other considerations.

### **3.2 The question**

*Key question – should HKSARG seek a merger?*

The consideration of whether to merge starts with the question which we are seeking to address: is there, on the evidence available, a sufficient case for the Government, as sole shareholder in KCRC and majority shareholder in MTRCL, entering into commercial discussions with the corporations (and MTRCL in particular) on the exchange terms associated with a merger between the two, on the presumption that:

- the assumptions made by Rothschild, following discussions with the two corporations and with HKSARG, regarding the likely level of synergies, will be validated and / or improved through the due diligence process;
- an appropriate settlement will be reached with MTRCL on fare setting mechanism as part of a merger deal;
- a transaction which creates greater shareholder value and realises increased proceeds over and above the status quo can be constructed; and
- a board and management team can be constituted which blends the best of the talents of both organisations.

This section focuses on answering this question.

### **3.3 Decision criteria**

Given the current shareholding structures, MTRCL and HKSARG will be the two key decision making parties in any merger, and each will be evaluating the potential transaction through different decision making criteria. In formally considering a proposition, the independent directors of MTRCL will be forming a judgement on the merits of a proposition from the perspective of minority shareholders. We highlight below some of the key factors in which they will each likely consider in arriving at a decision.

*HKSARG should see to maximise value and proceeds, consistent with other objectives*

HKSARG decision parameters:

- From a financial perspective, in considering which alternative would maximise proceeds, HKSARG will be mindful of the following:
  - the likelihood of the proceeds from the sell down in a merged company exceeding the aggregate proceeds from any IPO of KCRC plus a secondary sale of MTRCL: HKSARG should consider this issue in absolute cash terms, in net present value terms and, possibly, by reference to the fiscal years in which such proceeds might be realised; and
  - the probabilities of a secondary MTRCL sale or any IPO of KCRC being completed in the requisite timeframe, given the issues associated with the equity stories of the corporations.
- In terms of shareholder value, HKSARG has a clear interest in protecting and maximising the value its stake in MTRCL and therefore to the extent that the merger terms facilitate a price improvement for MTRCL shares, HKSARG is the largest beneficiary.

*From a financial perspective, we assume that HKSARG will adopt the solution which maximises value and proceeds and expedites the realisation of those proceeds.*

*MTRCL will seek to maximise shareholder value*

MTRCL decision parameters:

- For MTRCL's minority shareholders, any transaction should safeguard value to these investors and, furthermore, attract them to a deal. More specifically, MTRCL would wish to merge with KCRC under terms which create shareholder value (including minority shareholder value) but without undue risk in achieving such benefits;
- The company would examine the effects of the following factors on its current value:
  - synergies and fare cuts – the extent to which synergies are used for fare cuts (or boarding charge modification) will be taken into account in the consideration of the transaction and the value of KCRC;
  - loss of fare autonomy – whereas HKSARG, as discussed, views the possible merger as an opportunity to review and potentially modify the current fare setting arrangements, any modification to fare autonomy is likely to be viewed cautiously by MTRCL and its value impact, and the ability of the board to exercise sufficient control over the business, is likely to be considered carefully; and
  - equity story benefits / re-rating – MTRCL is likely to regard a merger as a means through which to enhance its growth prospects and improve its equity story.

*Overall, MTRCL will seek a deal which improves shareholder value.*

*MTRCL will measure any proposals to merge against status quo with particular reference to fare autonomy*

MTRCL will compare the result of any merger proposition with the status quo in framing a recommendation to shareholders. This means that any revision to fare autonomy, which MTRCL currently enjoys, will be weighed alongside the merger terms and need to be taken into account in any implementation process.

### 3.4 Merger versus no merger

*Main rationale for HKSARG would be to accelerate and facilitate receipt of proceeds*

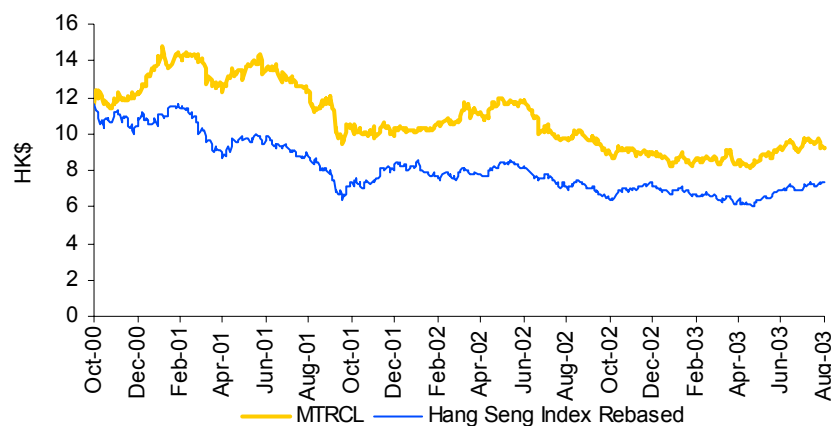
One of the reasons for HKSARG to undertake a merger would be to facilitate and accelerate the release of shareholder value and realisation of proceeds from its investments in the two corporations. Whilst there are plausible options for either corporation to raise finance from the debt markets and distribute these to HKSARG, we have focused on merger structures which retain a listing and therefore assure the continued access to equity capital markets. Furthermore, KCRC has substantial investment obligations over the medium term which impact on its ability to absorb additional debt.

#### a) MTRCL

We have set out below the relative share price performance of MTRCL since its IPO in order to demonstrate the trend of its share price performance since that point.

*Share price performance since IPO*

*MTRCL share price has traded down since IPO*



It can be seen from the chart that, while the shares of MTRCL have outperformed the Hang Seng Index, shares have traded below IPO price for an extended period from September 2002 to June 2003. Although the MTRCL share price has risen recently (as of the date of this report) due to the overall improved market sentiment, the MTRCL share price<sup>5</sup> is not realising fully its potential.

*Source: Bloomberg*

<sup>5</sup> March 2004 update: stock price now HK\$12.10: 17 March 2004

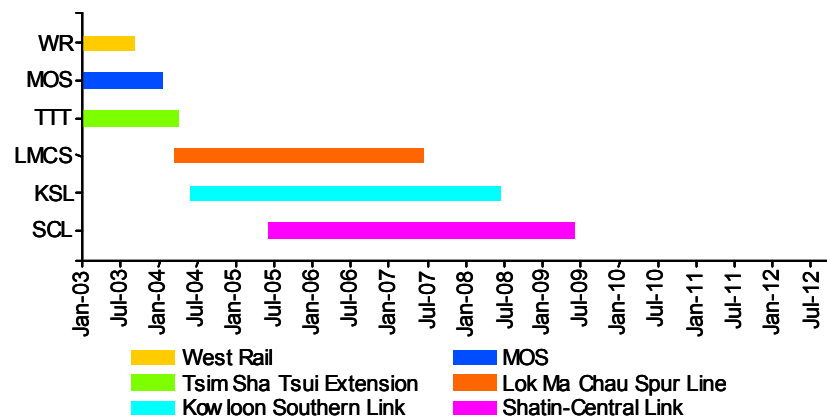
This share price performance is due to uncertainty regarding MTRCL's prospects mainly in respect of:

- a decision in relation to the potential merger;
- the potential loss of fare autonomy;
- relatively flat patronage / lack of growth drivers (compounded by the after-effects of SARS);
- the reluctance of MTRCL to impose a fare increase and the revenue effects of the concessions it has offered;
- the loss of the SCL project as a clear growth driver; and
- uncertainty over the funding of new projects.

It should also be noted that (as of the date of this report) many analysts have a target share price well below the current trading level.

## b) KCRC

We set out below our understanding<sup>6</sup> of the timeline for the completion of major projects currently undertaken or to be undertaken by KCRC:



The cash requirement of the investment programme is the main reason why KCRC is cash negative for several years. This poses complications for an IPO of KCRC with investors likely to be reluctant to pay a full measure of value for corporations with sustained negative cash flows. If there were any changes to the timing of the schemes to which KCRC is committed, then the "IPO window" would vary.

<sup>6</sup> March 2004 comment: there have been updates to the timeline for the completion of individual projects mentioned above since the date of this report



*Source: KCRC*

*Note: this chart does not have regard to any potential slippage in projects, including recent comments regarding SCL*

Other key timing issues include:

- timing of any IPO relative to the delivery of the infrastructure projects referred to above and the need to demonstrate, within the track record period, a representative financial outcome of material investments;
- time gap between the secondary offering of MTRCL and the IPO of KCRC; and
- the required full scale privatisation / IPO process including legislation, due diligence, prospectus disclosures and marketing programme.

*KCRC IPO unlikely before 2005/06  
in our view*

Although we have not conducted a detailed review of the IPO prospects of KCRC, we believe that any listing would be unlikely to take place before 2005/06 and possibly later. A KCRC IPO, therefore, is likely to be more distant than the completion of a merger and a subsequent sell-down of equity in the enlarged company.

*Merger offers more rapid and  
certain access to equity markets*

We have assessed in Section 6 respectively the timing of and prospects for the secondary offering of MTRCL, and potential IPO of KCRC, and have set out our valuation of KCRC and the likely quantum of proceeds from the two transactions. In summary, we conclude that taking into account the factors above and our indicative value of KCRC, a merger of the railway corporations, in our view, offers HKSARG a higher likely aggregate amount of proceeds from the equity markets for the railway corporations, quicker access to the equity markets to deliver these proceeds and a greater degree of confidence in the achievability of that outcome.

### 3.5 *Financial advantages and disadvantages of a merger*

As financial adviser to HKSARG, we first address the question of whether to merge by examining the financial advantages and disadvantages of doing so:

Advantages of a merger	Disadvantages of a merger
<ul style="list-style-type: none"> <li>• A merger would be a company transforming transaction which should greatly strengthen the equity story of MTRCL / the merged entity</li> <li>• Merger provides a platform to realise synergies and to create a more valuable company</li> <li>• Value realisation from KCRC could be accelerated (i.e. privatisation is effectively brought forward)</li> <li>• HKSARG reaps higher present value benefits (i.e. receiving proceeds earlier)</li> <li>• Larger balance sheet of the merged entity should facilitate future investment to improve further Hong Kong's railway infrastructure</li> <li>• The cash flow profiles of the two businesses are complementary</li> <li>• HKSARG could enhance the prospects of future asset disposals</li> </ul>	<ul style="list-style-type: none"> <li>• The preliminary synergy assessments indicate that operational synergies are meaningful but not substantial in the context of the scale of the two businesses, albeit that the capital synergies could be significant</li> <li>• A merger predicated on a change in the fare setting mechanism is likely to have adverse value consequences; the benefit of the merger would need to outweigh any negative value impact of the loss of fare autonomy</li> </ul>

*Subject to achievement of synergies, strong rationale for a merger*

From a financial perspective, there is a strong rationale for a merger subject to the achievement of net synergy benefits. Our analysis conducted to date indicates that, for the particular option of MTRCL acquiring KCRC, a merger is likely to generate higher proceeds for Government than the status quo, provided that the synergies can be realised.

### 3.6 *Non-financial advantages and disadvantages*

*Non-financial issues also impact merger decision*

In addition to financial issues, the proposed merger must be examined from the perspectives of transport / planning and environment. We have summarised our views as to the advantages and disadvantages:

#### a) Transport / planning issues

Advantages of a merger	Disadvantages of a merger
<ul style="list-style-type: none"> <li>• The merged entity will be in a stronger position to compete with other modes of transportation in Hong Kong and hence potentially improve the overall service standards of transportation in Hong Kong</li> <li>• Creates opportunity to implement any fare setting mechanism or guidelines as well as fare reduction.</li> <li>• Potentially enables the abolition / reconfiguration of a second boarding charge</li> <li>• Merged entity is expected to have more convenient transfer arrangements</li> <li>• There are no apparent insurmountable operational and technical hurdles</li> </ul>	<ul style="list-style-type: none"> <li>• Public demands for alternative bus services needs to be addressed</li> <li>• The merger will diminish / eliminate competitive bidding for new projects</li> </ul>

*Fare setting mechanism could be introduced in conjunction with merger*

The key consideration from a transport perspective is the possibility to modify the fare setting arrangements. KCRC and MTRCL (and particularly the latter) are likely to be more prepared to examine any modifications to fare autonomy in the context of a merger rather than as a stand-alone proposal.

## b) Social/environmental issues

Advantages of a merger	Disadvantages of a merger
<ul style="list-style-type: none"> <li>• Possible abolition or reconfiguration of the second boarding charge should generate an increase in railway patronage and consequently reduce the public's reliance on road-based transportation</li> <li>• Further bus route rationalisation may be possible given the potential defection of bus passengers</li> </ul>	<ul style="list-style-type: none"> <li>• Synergies from a merger may involve job losses, although we understand that the effect on front-line staff may be low as staff are redeployed on an expanding railway.</li> </ul>

### 3.7 Recommendation

Having identified above the key policy objectives for HKSARG in assessing a potential merger, we have set out below a table scoring the desirability of a merger against key policy objectives:

	Key policy objectives	Merger score	No merger score
<b>Financial</b>	Maximise proceeds	●	●
	Timing of proceeds – as early as possible	◐	◐
	Maximise synergies	●	○
	Maximise value of the corporations together	●	◐
	Improve equity story of MTRCL	●	○
	Favourable impact on upcoming Asset Disposal Programme	●	◐
<b>Transport</b>	Raise scope for fare reductions	+	◐
	Facilitate implementation of fare setting mechanism	●	◐
	Facilitate passenger interchange	◐	◐
	Support railway as the backbone of transport in Hong Kong	●	◐
	Increase competition – service and projects	◐	●
<i>Key:</i>	● <i>Best / achieved</i>	○ <i>Worst / not achieved</i>	

*We believe benefits of a merger significantly outweigh disadvantages*

The most significant uncertainty surrounding the merger is the level and timing of realisable synergies. Whether the level of synergies can exceed the cost of realisation (inclusive of any merger costs) should underpin any decision regarding the merger. The estimate of the quantum of synergies, along with an estimate for realisation costs, should be firmed up and improved. Based on the current assessment of synergies available that have been presented to us, we believe that the operational synergy benefits of a merger will outweigh the disadvantages. In addition to these operational synergies, there are important financial synergies associated with a merger, related in particular to the re-rating of the equity.

Without a merger, we have concerns over whether HKSARG would be able to realise a significant amount of proceeds from a secondary offering of MTRCL in the near term at an attractive price<sup>7</sup>. A merger could also accelerate and optimise the realisation of shareholder value of KCRC, and the preparatory stages of a merger would preserve flexibility for HKSARG, as the steps taken to facilitate the merger (e.g. corporatisation) could be implemented to facilitate an IPO of KCRC if an agreement on merger terms could not ultimately be reached with MTRCL.

*Recommendation*

Given the financial benefits of a merger and the apparent transport and wider benefits that should also arise, we recommend that HKSARG should proceed with a merger of the railway corporations and initiate dialogue with MTRCL over the terms of such a transaction.

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<sup>7</sup> March 2004 update: equity market conditions have substantially improved since the date of this report

## 4. How to merge?

### 4.1 Structuring parameters

*Key parameters drive how to merge business*

There are a number of key structuring parameters that must be examined in advance of any assessment of potential merger structure. The vital parameters we would highlight include:

- (i) whether to retain an integrated railway or separate infrastructure ownership from operation (or from aspects of operation); we see the issue of whether to split the ownership from the operation as a structuring question informed by policy issues. Although there are benefits in separation, there is, on balance, a strong rationale to retain the integrated structure, from a financial as well as operational perspective;
- (ii) whether to effect a merger through a holding company structure or some form of jointly-controlled entity; we consider such jointly-controlled entities as effectively joint ventures. Most such structures have been used in cross-border mergers mainly to address legal, tax or “national interest” issues. As such, the special circumstances that usually support the creation of a jointly-controlled entity do not have much relevance in the context of a proposed merger;
- (iii) the extent to which synergies can be maximised; in combining the businesses, it should be an objective to simplify the post-merger operational structure so as to enable the fullest possible integration of the businesses and thereby maximise the scope for synergies. Structures which create impediments to such integration (e.g. each network remaining in a separate company) are likely to hinder the realisation of the full benefits of the combination; and
- (iv) identity of the top company; we believe that the optimal transaction structure is one in which MTRCL’s listing is maintained, and where the merger consideration is a blend of cash and shares. The primary rationale is that (i) any structure which does not make use of MTRCL’s existing listing removes an established, accessible route to the equity capital markets; (ii) a full merger between KCRC and MTRCL is most likely to achieve the greatest extent of synergies and, therefore, the greatest degree of benefit for shareholders and passengers; (iii) an element of share consideration for KCRC will be required in order to ensure that the merged entity remains on a robust financial footing; and (iv) the payment of some cash by MTRCL to HKSARG within the consideration allows Government to realise some proceeds which are not subject to equity market conditions and, potentially, earlier than any MTRCL 2 sale.

We have considered a wide range of structural alternatives<sup>8</sup> for a potential full or partial combination of the businesses, based on the parameters highlighted above and the objective of speed and simplicity of implementation, should a decision to proceed be taken. We have discussed those structural options with officials as part of our iterative development of advice.

## **4.2 Recommendation**

*MTRCL as lead partner is a "merger of equals"*

For the reasons set out above, we believe that MTRCL should be the acquiring company in any merger, although the transaction would be seen as a "merger of equals". In selecting the optimal merger structure, we believe that a potential corporatisation of KCRC would preserve HKSARG's flexibility in pursuing an IPO if it were not able to agree appropriate terms with MTRCL in any merger discussions; it may be that, if discussions on a merger proceed well, HKSARG may not need the IPO as a fall back option and that a sale of KCRC's underlying assets could be contemplated. The ultimate decision on merger structure will also be informed by detailed legal considerations at the implementation stage of any merger, which will also need to consider the means of legal transfer of the KCRC business to MTRCL on the completion of a merger. There are human resources and organisational issues that would need to be addressed in integration planning.

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<sup>8</sup> March 2004 comment: the 12 August 2003 Report examined structural issues in detail. These issues have been omitted from this abridged report on the grounds of price sensitivity.

## 5. Regulation and fares

One of the key aspects of any potential merger is the possible amendment to the current fare autonomy that the two corporations currently enjoy.

### 5.1 Fare autonomy?

*Regulation has a considerable impact on shareholder value*

The fact that both corporations enjoy fare autonomy is not only a matter of historic development but also one related to the competitive environment. Regulation, in our view, is best suited to markets and situations where competition does not exist or is sufficiently imperfect to allow a high degree of monopoly power to be used. This is unlikely to be the case in the Hong Kong railway market as the competition from the bus companies is strong.

We believe that regulation has a cost in terms of its effect on cost of capital. It sets a framework for review which can “second guess” the management of the regulated entity and does so with a timeframe which is shorter than those adopted by companies in undertaking extremely long life investments, thereby creating uncertainty.

Notwithstanding these value issues, we recognise that deflation has not resulted in lower railway fares and therefore it may be desirable from a wider policy perspective to modify the fare setting arrangements to facilitate reductions in fares in a deflationary environment where the incentives on the corporations to reduce fares may be weak. However, it is recognised that the corporations have voluntarily introduced a significant range and scale of concessionary measures<sup>9</sup>. If there is a policy imperative to move to a new fare adjustment mechanism, the key issue from a value perspective is creating transparency and predictability of the outcome, allowing costs to be passed through and incentivising and remunerating investment in a growing railway.

### 5.2 Mechanism?

ETWB has proposed a fare adjustment mechanism<sup>10</sup> with a formula which creates an index which is intended to track the cost base of the company. This index would be used to indicate the direction and extent of fare changes that would be required if

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<sup>9</sup> March 2004 comment: these concessionary measures were summarised in ETWB’s paper entitled “Public Transport Fares” of 1 August 2003 to the Legco Transport Panel

<sup>10</sup> March 2004 comment: the proposed fare adjustment mechanism is set out in ETWB’s paper entitled “Public Transport Fares” of 1 August 2003 to the Legco Transport Panel



fares were to track the cost base. We have reviewed the outline of the formula and provided our views on the formula as a basis of regulation, but we have neither participated in its development nor conducted due diligence on the calculations or the outcomes.

The concept of an external indicator on costs seems sensible to the extent that the cost index accurately tracks the true costs of the corporation. However, there are a number of issues that need to be addressed in any formula. Firstly, the operating cost component of any cost reflective index should reflect the genuine underlying costs of operation (eg wages). Secondly, the capital cost component of the proposed fare mechanism should reflect the corporations' respective weighted average cost of capital to fully remunerate lenders and shareholders and incentivise investment.

In addition, the issue of who ultimately sets fares will need to be addressed. The directors of a private sector company have fiduciary duties towards the company, which they will need to have regard to in setting fares: that is, directors may need to take certain fare setting decisions to protect the financial position of the company.

### **5.3 Fare cuts**

The merger should give rise to synergies which can be recycled into lower fares for the travelling public.

#### *Synergy assessment*

HKSARG should develop a clearer understanding of the profile and scale of synergies (after discussion between corporations) before determining the final approach to fare cuts, and this will require the corporations to engage in active and constructive dialogue to identify the synergies after any decision to proceed with merger discussions.

## 6. Valuation issues

*Valuation of KCRC is key to the transaction*

One of the key determinants of the feasibility of a merger is the stand-alone value of KCRC. We have conducted an indicative valuation to determine a range of equity values that we believe the market would attribute to KCRC on the basis of the business and its prospects as it now stands.

### 6.1 Preliminary valuation of KCRC

#### a) Our approach to valuation

*Sum of the parts*

We have valued KCRC as a stand-alone entity operating under fare autonomy. We conducted the valuation by carrying out a review of the company's underlying future cash flows based on the company's current business plan projections.

We have conducted our valuation on a sum of the parts basis. This methodology is commonly used where business units are at different stages of the business development cycle. Given that KCRC is a multi-line railway business, that many of its projects (e.g. West Rail, Shatin Central Link, Kowloon Southern Link and East Rail Extensions) have yet to be completed, and that East Rail is in a mature state, this methodology is suitable to apply to KCRC. In valuing each of the components of the business, we have used a discounted cash flow (DCF) valuation, where the company's future cashflows are discounted at an assessed cost of capital to arrive at a present value, as well as multiple-based valuations (where applicable), by reference to a peer group of comparable quoted companies. The enterprise values of each line are aggregated to derive the enterprise value of the business as whole and the net debt is subtracted to arrive at the indicative equity value.

KCRC has invested substantially in new lines, primarily West Rail and the East Rail Extensions, which are not yet on stream<sup>11</sup> and therefore the near term financial results of KCRC will not represent the full potential of these lines. Therefore, to rely on a multiple-based approach would not attribute full value to those lines; furthermore, KCRC will invest substantially in new lines over the medium term, including the Shatin Central Link and Kowloon Southern Link, and these investments result in KCRC having negative cashflows in the medium term. For both these reasons, the DCF approach is the most suitable to the valuation of KCRC, although it is highly sensitive to the assumptions made.

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<sup>11</sup> March 2004 comment: West Rail now operational

*DCF valuation is our primary methodology*

Our valuation exercise is therefore anchored on the DCF methodology. The future cashflows and a Terminal Value are discounted at a calculated weighted average cost of capital to arrive at an estimate of the current value attributable to KCRC. As in any DCF calculation, the value of the businesses is highly sensitive to the Terminal Value assumptions.

### **b) Cost of capital**

Rothschild has conducted a weighted average cost of capital analysis to derive a “market reflective” WACC for KCRC to be applied to KCRC projections.

### **c) Sum of the parts valuation**

[The indicative valuation of KCRC relies on the long range financial projections of KCRC and other commercially and market sensitive information. The indicative valuation and analyses derived there from have accordingly and has been omitted from this abridged report.]

The valuation range we have derived represents a preliminary view on KCRC’s market value. We have modelled information received from KCRC and made certain assumptions about tax capital allowances, depreciation and interest rates to arrive at forecast financial statements and a preliminary estimate of KCRC’s value. Our indicative valuation has not been conducted to the level of detail or with the extent of due diligence that would be required for any transaction.

## **6.2 Fiscal considerations / proceeds**

*We have sought to estimate incremental proceeds available from a merger*

In addition to the stand-alone value of KCRC, we have sought to estimate the likely proceeds implications for the Government on the basis of “merger” and “no merger” scenarios. As discussed in Section 3, for illustrative purposes, we assume that if there is no merger, HKSARG would wish to proceed with an IPO of KCRC in due course and a secondary sale of MTRCL.

We have summarised below the key issues which would drive value, proceeds or timing differences between the two scenarios:

- Discount rates: we value KCRC using our assessment of a market-based Weighted Average Cost of Capital (“WACC”). On IPO, the equity markets would use such a WACC estimate for KCRC in valuing the business.

MTRCL, in acquiring KCRC, would value the cash flow using MTRCL's own WACC to calculate the benefit to its shareholders

- Synergies: on a merger, synergies would be likely to arise and we have highlighted earlier the importance of validating these estimates.
- Re-rating: we believe that the possibility of a merger is partly reflected in the share price of MTRCL even though no decision has been taken. If there were a decision not to proceed, the equity market would focus closely on the business fundamentals of MTRCL and would ascribe a lower value to MTRCL's shares than their present value: this is a loss to shareholders – including HKSARG as the significant majority shareholder – of not doing a deal. Conversely, as the merger is only partially reflected in the price, we believe that a deal at a fair value, which enhanced MTRCL's growth prospects, should be reflected positively in the price/earnings ratio on which the stock trades. We believe that if there were a merger, the growth prospects of KCRC/MTRCL combined would be enhanced.
- Fare setting: the effect of any new form of regulation would depend on its precise nature.
- IPO discount: if there were an IPO of KCRC, the shares would be priced at a discount to the value of KCRC to enable the sale to investors and such discount would exceed that on an MTRCL secondary offering.

The table below summarises the financial effects of each of the factors referred to above:

[The table relies on the indicative valuation of KCRC and on other commercially and price sensitive information. This analysis has accordingly been omitted from this abridged report.]

*We believe HKSARG will receive more proceeds via a merger than without one*

In summary, taking all these factors in account, we believe that there is a material value differential between a “merger” and “no merger” scenario, with a merger generating more value for HKSARG, as well as affording scope for fare cuts. The Government would also receive more proceeds under a merger than without one. Furthermore, HKSARG should have greater confidence in being able to realise equity from sales in the equity capital markets and such proceeds should, using MTRCL's existing listing, be achievable in a more rapid timeframe than via the separate process of MTRCL secondary offering and KCRC IPO.

## 7. Consideration structure

In this section, we address the issue of creating a transaction which is likely to receive shareholder approval, whilst meeting HKSARG's objectives. Key to this is the consideration structure; that is, how government receives its value in a merger between KCRC and MTRCL.

### 7.1 MTRCL shareholder approval

*Transaction will need approval of MTRCL minority shareholders*

HKSARG's status as the sole shareholder of KCRC and a majority shareholder in MTRCL would cause the transaction to be classified as a "connected transaction." Since an acquisition of KCRC by MTRCL would not fall into the four transaction categories for which MTRCL is granted a waiver, the Listing Rules require the Government to abstain from voting and to allow the minority shareholders of MTRCL to decide: essentially over 50% of the minority shares voted (whether in person or by proxy) at the Extraordinary General Meeting must be in favour of the transaction for it to be approved.

*We have examined the consequences of several consideration structures*

We seek to address the following in the context of selected illustrative consideration structures:

- would the merger likely be a transaction capable of being recommended by the MTRCL Independent Board Committee to minority shareholders?;
- would the potential transaction structures, tailored to meet Government objectives, enable the enlarged company to operate with a financially viable capital structure?; and
- what are the fiscal implications for HKSARG under such transaction structures?

*We believe MTRCL will consider merits of a merger on the basis of three key criteria*

The minority shareholders of MTRCL will undoubtedly seek a transaction which would, as a minimum, maintain the value of their shareholdings. For it to lead to a potential price appreciation, the transaction / investment should fulfil two key objectives which are set out below.

#### a) Earnings enhancement

*Transaction should be earnings enhancing*

Any transaction with KCRC should be earnings enhancing over the medium term to be potentially recommendable to shareholders. In order to increase the likeliness of earnings enhancement, the two corporations should work together to firm up the magnitude and / or achievability of the likely synergies arising from the transaction during the negotiation process.

Another factor that significantly influences earnings enhancement / dilution is the consideration structure. MTRCL should aim to strike a balance between the burden of acquisition debt interest and the cost of earnings dilution through issuing shares. Being a public corporation and accountable to shareholders, MTRCL would be incentivised to select a transaction structure which facilitates earnings enhancement. The relative “costs” of debt and equity would indicate that MTRCL should pay as much cash consideration as possible, subject to the constraints of its financial profile.

### **b) Long-term viability of the merged entity**

*Balance sheet of enlarged company should not be put under undue strain*

Although one of the priorities for HKSARG is to maximise proceeds from any merger, the transaction itself should not bring about a substantial change in the capital structure of the enlarged entity such that the balance sheet of the merged entity is put under excessive financial strain.

Whilst the need to extract financial proceeds is understandably also a high priority for HKSARG given the budget deficit, it should be noted that a highly leveraged consideration structure would enable the Government to receive substantial proceeds, but with potential risks to the long-term viability of the railway corporation and hence the Hong Kong railway system. A balance sheet carrying a high debt level would hinder the enlarged entity’s potential ability to take on new projects.

*The merged company must be financially robust*

We have assessed the ongoing financial viability of the enlarged entity, as impacted by various consideration structures, in the section below.

## **7.2 Benchmarking financial outcomes against the status quo**

[This section of the report utilises KCRC and MTRCL financial projections, Rothschild’s indicative valuation of KCRC and other commercially and price sensitive information. This analysis has accordingly been omitted from this abridged report].

## 7.3 Alternative consideration structures

### Structuring assumptions

*We assume merger is effective end 2004*

In examining the feasibility of alternative consideration structures, we have illustrated the effects of MTRCL's acquisition of KCRC through various combinations of cash (from new debt) and shares through financial modelling. As previously discussed, we believe that a realistic timeline would see the merger completing in Q3 or Q4 of 2004 and thus, for the sake of simplicity, we assume that the transaction (i.e. actual combination of the two corporations' financial statements) would occur on 31 December 2004.<sup>12</sup>

We have made assumptions about the level of capital and operating synergies and the profile with which they would arise.

We have assumed, as part of the condition for the Government's approval of any merger, a fare reduction on both corporations' fare revenues beginning in 2005. This fare cut would decrease the revenues of the combined entity in 2005 and thereafter since the post-2005 fares have a lower base from which to increase: we have not taken into account any price elasticity, notwithstanding the competitive environment in which the railway corporations operate. We have not modelled in this analysis any effect of a change to the fare setting mechanism.

### All cash transaction

*All-cash deal modelled*

We have examined the effects of an all-cash acquisition of KCRC by MTRCL on the basis of the financial projections provided to us by the two corporations: this would maximise the cash proceeds available to HKSARG under such a merger structure. However this consideration structure leaves the enlarged MTRCL highly leveraged, susceptible to external shocks and at a risk of a rating downgrade notwithstanding governmental support.

[Table indicating financial effects of merger on MTRCL and financial position of the enlarged organisation under this consideration structure utilises KCRC and MTRCL financial projections, Rothschild's indicative valuation of KCRC and other commercially and price sensitive information. This analysis has accordingly been omitted from this abridged report].

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<sup>12</sup> March 2004 comment: financial close now expected to occur substantially later than this date

## Cash and shares transaction

Given the financial strain imposed under the above scenario, we have modelled the effect of a merger structure where HKSARG receives the majority of its consideration in shares. Our illustrative cash and shares transaction structure creates a financial profile of the enlarged organisation, measured by the FFO cover ratio, which is sustainable.

[Table indicating financial effects of merger on MTRCL and financial position of the enlarged organisation under this consideration structure utilises KCRC and MTRCL financial projections, Rothschild's indicative valuation of KCRC and other commercially and price sensitive information. This analysis has accordingly been omitted from this abridged report].

### **7.4 Implications of the merger on the corporations' existing credit ratings**

*We have considered the credit rating issues posed by a merger*

KCRC's and MTRCL's existing credit ratings are based primarily on the two corporations' ability to "fall back" on the Government in events of financial distress. The companies consequently are enjoying ratings equivalent to that of HKSARG (domestic currency AA- / foreign currency A-). As a result, any merger would need to be sensitive to this and accommodate in its terms the maintenance of this support. Government support for the railway companies in Hong Kong has generally been taken to exist by the credit rating agencies by way of the following:

#### ***a) HKSARG's obligation to purchase MTRCL's assets at higher of book or market value***

The Government has committed, through the Operating Agreement, to "purchase MTRCL's assets at the higher of book or market value" in the event that the company's franchise is revoked prior to expiry. Since MTRCL is currently trading at a discount to its Net Asset Value (book value), the constraint is bound by MTRCL's Net Asset Value of c.HK\$56bn (as per its 2002 accounts).

#### ***b) Maintaining controlling shareholder status (>50%)***

As long as HKSARG is committed to maintaining a shareholding above 50% in the merged entity in the foreseeable future (e.g. 20 years), the credit rating agencies derive comfort from the fact that HKSARG has a vested interest in ensuring that the merged entity remains financially robust.



*c) Favourable regulatory and operational environment*

The most important issue under this heading is the change in the fare setting arrangements currently under contemplation. Standard & Poor's has, however, highlighted important factors in assessing the impact of any fare setting mechanism, including:

- a. Transparency of the mechanism;
- b. Cost recovery; and
- c. Permitted rate of return.

The fare setting mechanism defined will clearly need to be sensitive to these issues.

*d) Availability of Government support for earning acceptable returns on new projects*

From a rating perspective, the principal issue associated with new projects will be the perceived risk that the merged company might take on, either through the merger process or subsequently, projects that would not yield a commercial rate of return.

**7.5 Property related considerations**

The property related income of MTRCL provides support to the profit and loss account, both as regards rental income and property development projects. Any transaction involving the property aspects of the railway businesses in future would need to be carefully considered.

## **7.6 Preliminary conclusions**

*We believe a cash / shares consideration structure will result in a more robust merged company*

Based on our observations from preliminary financial modelling of the two corporations' projections, a highly leveraged transaction may jeopardise the enlarged entity's favourable credit rating and consequently its ability to raise debt at its current cost of borrowing. The prospective increase in the cost of borrowing would not only damage the company from a value perspective, but also raise the costs of new rail schemes to HKSARG as the costs of capital of the corporations rise.

If the merger were to use our illustrative cash and shares consideration structure, we believe that the rating agencies should maintain the credit rating (subject to the fare setting mechanism) provided that they are assured as to HKSARG's ongoing strong support for the enlarged entity.

In proceeding to commercial negotiations on the terms of a merger, HKSARG should therefore seek to strike a balance between maximising up-front proceeds and placing the enlarged business under undue financial strain through an excessively leveraged capital structure, which would negatively affect the equity value of the enlarged entity, and which would, in any event, leave HKSARG at risk of not securing the MTRCL minority shareholder approval which it needs to execute the transaction.

## 8. Conclusion

*Merger, on balance, beneficial*

We have analysed the KCRC / MTRCL merger against the background of our understanding of HKSARG's objectives and against the alternative of, in the absence of a merger, a secondary sale of MTRCL and a potential IPO of KCRC in order to realise proceeds.

We believe that a merger between the two corporations would be beneficial on sensible terms of exchange, fare reductions and regulation, and that HKSARG should proceed with discussions on the terms of a merger.

Such merger discussions would need to progress rapidly to achieve flexibility for a MTRCL secondary sale in 2004/05 and should commence with a vigorous investigation of the synergies available from any transaction.