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Legislative Council

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Bills Committee on
Mass Transit Railway Bill

Minutes of meeting
held on Tuesday, 7 December 1999, at 4:30 pm
in Conference Room A of the Legislative Council Building

Members present : Hon Mrs Miriam LAU Kin-yee, JP (Chairman)
Hon Kenneth TING Woo-shou, JP
Hon Cyd HO Sau-lan
Hon Edward HO Sing-tin, SBS, JP
Hon Eric LI Ka-cheung, JP
Hon NG Leung-sing
Hon Mrs Selina CHOW LIANG Shuk-yee, JP
Hon Ronald ARCULLI, JP
Hon Ambrose CHEUNG Wing-sum, JP
Hon CHAN Yuen-han
Hon CHAN Wing-chan
Hon CHAN Kam-lam
Hon SIN Chung-kai
Hon LAU Chin-shek, JP
Hon LAU Kong-wah
Hon Andrew CHENG Kar-foo
Hon FUNG Chi-kin

Members absent : Hon HO Sai-chu, SBS, JP
Hon Albert HO Chun-yan
Ir Dr Hon Raymond HO Chung-tai, JP
Hon LEE Cheuk-yan
Hon Bernard CHAN
Hon Andrew WONG Wang-fat, JP
Hon Howard YOUNG, JP
Dr Hon TANG Siu-tong, JP

Public officers attending	:	**Transport Bureau** Mr Kevin HO Deputy Secretary for Transport (1) Mr Thomas CHOW Deputy Secretary for Transport (4) Mr Roy TANG Principal Assistant Secretary for Transport (3) **Finance Bureau** Mr Martin GLASS Deputy Secretary for the Treasury(2) Miss Jenny YIP Principal Assistant Secretary for the Treasury (I) **Department of Justice** Mr Jonothan ABBOTT Senior Assistant Law Draftsman Ms Betty CHOI Senior Government Counsel
Attendance by invitation	:	**MTR Corporation** Mr Clement KWOK Finance Director Mrs Miranda LEUNG Corporate Relations Manager **Merrill Lynch (Asia Pacific)** Mr David DUNN Managing Director Mr K L WONG Managing Director

Action

Goldman Sachs (Asia)

Mr Timothy DATTELS
Managing Director

Miss Shirley FUNG
Managing Director

Clerk in attendance : Mr Andy LAU
Chief Assistant Secretary (1)2

Staff in attendance : Miss Connie FUNG
Assistant Legal Adviser 3

Miss Irene MAN
Senior Assistant Secretary (1)6

I Meeting with the Administration

(LC Paper No. CB(1)536/99-00(01) - List of follow-up actions
LC Paper No. CB(1)536/99-00 (02) - Process of Initial Public Offering and Valuation Considerations)

The Chairman informed the meeting that written submissions from various sectors on the Bill were being received and circulated to members for information. She also drew members' attention to the list of follow-up actions and the following meeting schedule:

Meeting		Subject
10 December 1999 (10:45am to 12:45pm)	-	Presentation on fare determination mechanism by international experts(I)
16 December 1999 (10:45am to 12:45pm)	-	Presentation on fare determination mechanism by international experts(II)
4 January 2000		
(9:00am to 11:00am)	-	Presentation by local deputations
(11:00am to 1:00pm)	-	Corporate Governance
13 January 2000 (4:30pm to 6:30pm)	-	Operating Agreement(2)

20 January 2000 (9:00am to 1:00pm) - Outstanding items

The schedule would be updated nearer the time.

Presentation by financial advisers

Overview of MTRC business

2. At the invitation of the Chairman, Mr Timothy DATTELS, Managing Director of Goldman Sachs (Asia), financial adviser to the MTR Corporation (MTRC), briefed members with the aid of an overhead projector on the nature of MTRC's business and the valuation considerations. He said that there were two components of MTRC's business, namely railway operations and property development. Railway investment was long-term in nature and required substantial capital expenditure and long pay-back period with steady modest returns. For example, the internal rate of return (IRR) calculated currently by MTRC was over a 40-year period, and hence a longer-term cash flow growth rather than current earnings had to be taken into account in considering the valuation of MTRC. On property development along its railway network, MTRC contributed immediate tangible value to all properties in the vicinity of its stations. This helped to generate profits which could be re-invested in other railway development of less returns and provided patronage growth to railway projects.

Valuation approaches

3. In order to fully capture the value of the Corporation, it was important to recognize the different components of its business. Railway was the most important component of the Corporation's business. In addition, property development and property investments also contributed to the Corporation's earnings. Each of these components needed to be assessed using separate valuation approaches.

Price/Earning ratio

4. Mr DATTELS pointed out that the Price/Earning ratio (P/E ratio) which showed the relationship between price per share and earnings per share was a popular valuation methodology for Hong Kong investors to determine the equity value of a business. However, this approach was not optimal at times of new railway extensions as the revenues for the new extensions required time to build up and the earnings were depressed in the early years of operation of new extension. As such, the P/E ratio might not fully capture the earnings and cash flow potential of the Corporation's investment.

Discounted cash flow analysis

5. For railway operations and property development cash flows, Mr DATTELS advised that discounted cash flow analysis (DCF), which valued all future expected cash receipts and expenditures in present terms, was the most appropriate valuation methodology because of the nature of the cash flows. He then briefed members on the critical components in valuing the business based on DCF analysis.

Net assets value approach

6. Referring to property investment, Mr DATTELS advised that the net assets value approach (NAV) was a commonly adopted valuation methodology for property investments in Hong Kong and was most appropriate for the valuation of the Corporation's property investments. There were three main components with the NAV approach: the determination of rental income; the determination of capitalisation rate (rate of interest used to convert a series of future payments into a single present value); and the determination of discount to NAV.

7. Mr DATTELS further advised that the valuation of MTRC depended on various factors. The value of railway operation was pre-dominantly driven by fare revenues, operating and financing costs, capital expenditures and future return on new investments.

Financial profile of MTRC

8. Mr DATTELS highlighted the salient points of the financial profile of MTRC. He pointed out that the MTRC urban lines had shown a relatively stable operating and financial performance for 20 years. With its average daily patronage of 2.3 million passenger trips and HK$3.5 billion earnings before interest, tax, depreciation and amortization in 1998, significant growth was expected in the long term due to the increase in population, further network development and continued service improvement.

9. Regarding the HK$35.1 billion Airport Express/Tung Chung Line launched in 1998, Mr DATTELS said that its operating performance was affected by the economic downturn, the decline in tourist arrivals, as well as assets depreciation and interest charges. However, significant growth was expected in the long term due to the economic recovery already underway, increased tourist arrivals, continued development of population centres along the airport railway, and other developments on Lantau such as the Disneyland Theme Park.

10. Referring to the Tseung Kwan O Extension which commenced construction in 1999 and was expected to be completed in 2002, Mr DATTELS advised that the original IRR for the project was 8.5% but the final return would depend on the total capital investment, future operating performance of railway and property prices of related property development. However, the total capital cost had already been reduced from the initial budget of HK$30.5 billion to HK$24 billion. Again,

Action

significant growth was expected in the long term as the predicted population had risen up from 440 000 to 520 000.

11. As far as property development was concerned, he pointed out that property development profits contributed over HK$1.4 billion to MTRC's profits in 1998. As regards property development along the Airport Express/Tung Chung Line, 11 of 15 packages had been awarded and MTRC had received over HK$15 billion in cash of net upfront payment. These were credited as deferred income on the balance sheet but would contribute towards earnings of MTRC upon completion of the property projects. Moreover, 23 packages for property developments relating to the Tseung Kwan O Extension would be awarded and were expected to be completed in 10 years.

12. Mr DATTELS highlighted the capital expenditure to be invested in the existing system, for example, approximately HK$8 billion for upgrading and maintenance of urban line system including the rolling stock modernization programme, installation of platform screen door and station improvement works, HK$3.2 billion for the Quarry Bay congestion relief scheme and approximately HK$1.5 billion on general maintenance in each of the last three years.

Pricing process

13. Mr DATTELS advised that the most important aspect of Initial Public Offering (IPO) was the determination of appropriate pricing for the shares. At the end of IPO preparation but prior to any formal marketing, the vendor would agree with the Global Coordinator on the preliminary valuation range based on a clearly defined regulatory framework, MTRC's historical operating and financial performance, future prospects and market positions. A relatively wide initial value range would be narrowed through the different stages of IPO marketing process to ensure that the final price could best reflect the market price through the comprehensive marketing process.

14. Mr DATTELS concluded that privatization of MTRC would be a historic and exciting opportunity for investors since the Corporation possessed many positive attributes. It had an excellent operational track record in terms of safety and performance, a strong financial profile and had established itself in the international capital markets; and a well-recognized and experienced management team who had showed unrelenting commitment to prudent commercial principles. Excellent growth prospects were expected both from the existing lines and future new extensions. Lastly, there was an immeasurable brand value in the MTRC name.

Overview of Initial Public Offering process

15. At the invitation of the Chairman, Mr David DUNN, Managing Director of Merrill Lynch (Asia Pacific), financial adviser to the Government, outlined to members the IPO process, the regulatory framework concerned and the impact of the process and framework on the valuation. He advised that the MTR Corporation Limited (MTRCL) would offer investors an opportunity to invest in an efficient and profitable urban transport system and a capital intensive with strong cash flows business. It would

also be a business with future growth opportunities and investors would have the chance to obtain exposure to the Hong Kong economy. However, a clear and predictable regulatory framework would have to be established to ensure that the Corporation would continue to provide high level of service and generate profits to finance its future growth.

Regulatory framework

16. Mr DUNN was of the view that the relationship between the Corporation and other stakeholders should be clearly defined. There would be mainly two groups of stakeholders: the regulatory stakeholders being the Government, the Legislative Council (LegCo), the Securities and Futures Commission (SFC) and the Stock Exchange of Hong Kong (SEHK) which were concerned with aspects such as performance, safety and service of the Corporation; while the commercial stakeholders were the passengers, investors and employees who cared for the commercial interests of the Corporation including the return from investment, growth opportunities and profitability of the Corporation. The primary regulatory instrument would be the Mass Transit Railway Ordinance enacted by LegCo whereas the detailed operational arrangements would be covered in the Operating Agreement to be signed between MTRCL and the Government. Another regulatory arrangement would be found in the protection regulation of SFC and SEHK.

Key components of an IPO process

17. Mr DUNN advised that the IPO process for a privatization exercise would usually require three to four months to complete following the passage of the legislation and the appointment of the Global Coordinator by the Government. The Global Coordinator was usually the listing sponsor to the stock exchanges for the Corporation who prepared and filed documentation with stock exchanges and relevant authorities on behalf of the Corporation, and was responsible for developing an effective positioning and marketing strategy. In preparation for the IPO, other third party professionals would also be appointed. The key components of an IPO process were to ensure that the valuation of the Corporation would be properly determined by the market. Since the IPO process fundamentally involved the preparation of a company for sale to the public, the sale could only proceed if the views of value between the vendor and the market were within the same range. However, this range could only be finalized when all the relevant processes were completed.

18. Elaborating on the key components of an IPO process, Mr DUNN advised that the first key component was due diligence and prospectus drafting. Due diligence allowed the Global Coordinator and the vendor to understand the company's business and identify risk factors in the prospectus. In a typical due diligence process, the Global Coordinator would visit the company's sites, interview the senior management and Government officials, analyze the company's financial situation and address relevant legal issues.

19. The second key component was valuation and marketing review. Valuation was an ongoing process throughout an IPO. After the due diligence process but prior to formal marketing, the Government, the company and the Global Coordinator would agree on an indicative price range to be used for marketing purpose. However, valuation range might vary from time to time depending on a range of factors including the market outlook, industry performance, the company's growth prospects and operational performance. The market perspective of these factors and their impact on the company would determine the ultimate valuation of the company.

20. The third key component was documentation and filings with relevant authorities. Listed companies were required by the stock exchange and relevant securities authorities to file a prospectus and other legal documents. The preparation of the prospectus required a thorough understanding of the company's business, the legal requirements in terms of disclosure and awareness of investors' concerns. The prospectus was used as a primary marketing document and was designed to ensure that investors had a good understanding of the company.

21. The last key component in an IPO process was marketing which consisted of four divisions. Firstly, the pre-marketing process introduced the offering in the marketplace and provided the Global Coordinator and the company with an understanding on the market sentiment and investors' concerns before the actual launch of the offering. It would also help potential investors in understanding the targeted company. Secondly, the roadshow process was a series of group presentation and meetings with potential institutional investors around the world. It provided an opportunity for the company's senior management, the Government and underwriters to communicate with one another and address investors' concerns. In listing MTRCL, extensive public relations campaign would be launched to maximize awareness for Hong Kong retail investors. The third division in the marketing programme was the bookbuilding process whereby the Global Coordinator would build a "book" indicating the investor demand for the offering during the pre-marketing period which accelerated towards the end of the roadshow process. The last division was the pricing and allocation process. The Global Coordinator determined an optimal pricing level and allocated shares to investors through the bookbuilding process in order to maximize IPO proceeds, enhance the quality of investors and ensure strong aftermarket performance. Trading of the shares would commence shortly after the pricing and allocation.

22. Sharing the concluding remarks of Mr DATTELS, Mr DUNN emphasized the strong attributes of MTRC and the importance of a clear and predictable regulatory framework.

(*Post meeting note:* The materials presented by Mr DATTELS and Mr DUNN were tabled at the meeting and circulated to absent members subsequently.)

Action

Members' response

Fare determination mechanism

23. Mr LAU Chin-shek asked whether the Administration would withdraw the privatization proposal if MTRCL would not be able to enjoy fare autonomy. The Deputy Secretary for the Treasury(2) (DS for Tsy) advised that MTRC had been enjoying fare autonomy and operating under the restraint of competitive forces for the past 20 years. He believed that the competitive pressure was the best regulator for the fare level of the Corporation. The imposition of a fare setting regime would have adverse impact on the investors' perception and negative effect on valuation. If the Administration was not confident enough to get value for taxpayers' money in the sale of MTRC, it would consider reviewing the whole process.

24. Mr LAU Chin-shek further enquired about the extent of influence on valuation and the calculation basis for such an extent if the fare level was to be regulated. In response, Mr DATTELS said that the regulatory framework of MTRC, especially the fare determination mechanism, was fundamental to the core of the investment business both for the fixed income investors and equity investors. Miss Shirley FUNG, Managing Director of Goldman Sachs (Asia), supplemented that a fare setting regime would affect credit ratings and increase the cost of debts. Since investors would usually refer to the past business performance of a company to determine future investment, a change in the company's regulatory framework, such as the introduction of the fare setting regime, would affect the investors' decision. In fact, the fare setting regime was only one of the many factors affecting the valuation of the Corporation and it was difficult to identify the influence of a single factor.

25. Both Mr LAU Chin-shek and Mr CHENG Kar-foo enquired about the possible impact on loan facilities if a fare regulatory framework was introduced. They asked if such impact could be quantified, particularly with reference to the introduction of a fare determination formula for regulatory purpose. In response, Mr DUNN said that imposition of any new regulatory framework would create uncertainty and would have an impact on valuation. It was impossible to measure this impact as investors would consider many other factors arising from the uncertainty. These considerations might lead to the discount of the valuation of the company currently operating under a market determined framework. Therefore, it would be best to preserve the existing operational environment.

26. Mr Edward HO enquired whether proposed shifting of the market-determined mechanism to a mechanism regulated by LegCo in fare setting would influence investors' view towards MTRCL as a corporation operating under prudent commercial principles. In response, Mr DUNN said that this major change would increase the degree of uncertainty significantly because the factors affecting the decisions of LegCo were more than the commercial issues affecting the decision of the Board of Directors of the Corporation.

Action

27. Mr LAU Chin-shek took the view that the fare had not been determined by market forces at all over the years, and MTRC had been increasing the fare in accordance with inflation and this had resulted in a reduction of the number of passengers. The number of passengers had however gone up again when the Corporation froze the fare last year due to public pressure rather than market forces. FD/MTRC responded that the fare levels of MTRC had close ties with market forces. He pointed out that passenger flow might not necessarily increase even when the fare was frozen, and that passenger flow had decreased even with the frozen fare last year. The Corporation was, hence, still operating under considerable competitive pressure.

Financial forecast and marketing

28. Mr SIN Chung-kai enquired about the projected DCF ratio between property development and railway business of the Corporation, and whether the shares issued by the Corporation would be regarded as real estate shares or railway shares. In reply, Mr DATTELS said that the percentage of the relative value of the two businesses would only be available nearer the time of listing after determining the regulatory framework to be adopted. Mr K L WONG, Managing Director of Merrill Lynch (Asia Pacific), advised that according to last year's performance, 10% of MTRC's total profits was derived from property development.

29. The Finance Director/MTRC(FD/MTRC) added that detailed forecast on the valuation of the Corporation at listing was not yet available. However, the earnings from property development would depend heavily on the future real estate market. Since the market was subject to fluctuations, more accurate projections could only be made nearer the listing time. He emphasized that MTRCL would be a railway corporation with property development serving only as a supplement for its returns.

30. As MTRC had to calculate its IRR in 40 years, Mr FUNG Chi-kin remarked that it was too long a period for investors to determine their positions of investment since the value of the business would be affected by many events happening during the period. Mr DATTELS believed that investors would seek long-term returns. They would also adjust their expectations with respect to the valuation of MTRCL every day. Mr DUNN added that the listing of the Corporation would be investors' opportunity to have an exposure to the Hong Kong economy.

31. Referring to paragraphs 6 and 7 of the information paper, Mr CHAN Kam-lam noted that the P/E ratio was not regarded as a suitable valuation method especially at times of operating new railway extensions due to numerous changing factors, such as regulatory and operational factors. He enquired about the weight of individual factors in affecting the equity value of the railway business. In response, Mr DATTELS explained that the condition of the financial market, the economic environment in terms of GDP growth and the operating performance were critical to overall valuation, and this had to be packaged with the overall regulatory framework set by the Government. The result might not be precise by evaluating the influence of individual aspects.

Action

32. Mr CHAN Kam-lam also enquired whether the IPO process would be promoted mainly to local or overseas investors. DS for the Tsy advised that the intention of privatizing MTRC was to encourage Hong Kong people to participate in the railway business; therefore, the Government would sell a large part of the shares to local investors and take into account the appetite of the local market in the promotion process. Mr CHAN took the view that the majority of shares, say 70% to 80%, should be sold to local investors whom he believed would find the investment opportunity very attractive.

33. Mr Ambrose CHEUNG enquired whether there would be a share option scheme for staff of the Corporation to participate in the privatization scheme. FD/MTRC said that MTRCL would encourage staff to own shares of the Corporation. Mr DATTELS advised that employee ownership and option plans were standard practices in many privatization schemes in the world. From the viewpoint of financial advisers, programmes which aligned the interest of the employees with that of the public shareholders should be supported.

34. Mr Ambrose CHEUNG also sought clarification on the reasons for adopting the bookbuilding process instead of underwriting in the marketing programme. Mr DUNN advised that there had been significant development in the capital market in the past five years, and it had been proven that better result could be achieved by using the bookbuilding process rather than the fixed underwriting process. Mr WONG supplemented that the bookbuilding process was not only adopted worldwide but was also commonly used in large-scale offering processes in Hong Kong. In response, Mr Ambrose CHEUNG commented that the underwriting method might reduce the risk borne by the Government but the cost would be higher. However, if the market did not react well to the privatization scheme, the whole listing plan would be affected by the bookbuilding method. He requested the Administration to re-examine the two options carefully. DS for the Tsy said that the Global Coordinator would advise the options when it was approaching the IPO stage. He informed members that the Administration would very shortly be taking the selection of Global Coordinators forward in parallel with the consideration of the legislatoin. He assured members that no contractual commitment would be made until after passage of the legislation.

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Conflict of roles

35. As the Government wholly owned the Kowloon-Canton Railway Corporation and the future West Rail and would be the majority shareholder of MTRCL, Mr Ambrose CHEUNG was worried that there might be conflict of interest when the Government had to decide which railway company was to develop a particular railway project. The Deputy Secretary for Transport(1) (DS for T(1)) advised that in developing new railway projects, the Government would grant the operating right to the railway company which could provide the best transport service and maximize returns. The composition of the shareholders concerned would not be a major consideration. FD/MTRC supplemented that MTRC had been considering all new railway developments on prudent commercial principles and would only invest in a project with reasonable IRR. This practice would continue after the listing exercise.

Action

Mr DUNN advised that it was common worldwide for a Government to be the shareholder and the regulator of a railway company after privatization. Arrangements between the Government and MTRCL on the regulatory framework would be addressed in the Operating Agreement, and this would provide sufficient protection for the investors concerned.

36. Given that the Government would be the majority shareholder and the regulator of MTRCL at the same time, Mr Ambrose CHEUNG considered that there would be conflict of roles. He expressed concern about Government's vote in connected transactions and questioned whether Government, being the majority shareholder, would be deprived of the voting right in the shareholders' meeting in accordance with the Listing Rules of the SEHK if the minority shareholders held opposite views against that of the Government in developing a new railway project. Mr DUNN advised that there would be a number of specific provisions in the Operating Agreement, the Memorandum and Articles of Association and the prospectus to address the member's concern. Nevertheless, it would be necessary to attract and ensure investors that the Corporation would take care of the interest of all shareholders through effective corporate governance. He was aware that the issues on corporate governance would be further discussed by the Bills Committee on 4 January 2000. Miss FUNG added that the Government would not be given preferential treatment despite its role as the majority shareholder. She assured members that the interest of minority shareholders would not be unduly affected.

37. FD/MTRC also explained that the Board of Directors of MTRCL would decide on the investment of a new railway project in the first place instead of the Government or other shareholders. As for whether the minority shareholders' consent had to be sought regarding the investment decision, there were different provisions in the Stock Exchange's Listing Rules for different circumstances. The Corporation had not yet discussed the subject with SEHK but he undertook to provide further information in this respect in due course. DS for the Tsy further advised that at present, the Government's two roles were represented by the Secretary for Transport as the regulator and the Secretary for the Treasury as the shareholder in the Board of Directors of MTRC and no conflicts had arisen. He believed that there should be no problem even with the introduction of new shareholders after the privatization exercise.

MTRC

38. Mr LAU Chin-shek sought further clarification on whether the Government or the minority shareholders would have the right to decide on the development of a new railway project, and how the interest of minority shareholders could be protected if they were not given the right to make the decision. In developing a new railway project, DS for T(1) pointed out that both the Corporation and the Government would consider the returns of the project. If the Corporation rejected the development, the Government might approach other interested railway operators to develop the project. However, if the development was an extension of the existing railway lines run by the Corporation but the Corporation refused to develop it under prudent commercial principles, the Chief Executive in Council could direct the Corporation to take up the project but would have to compensate the Corporation for the loss incurred. The

Action

interest of minority shareholders would thus be protected. He believed that the investment goal for majority and minority shareholders should be consistent and both would agree on operating the railway business under prudent commercial principles.

Staff arrangement

39. Referring to the written submissions from the Hong Kong Mass Transit Railway Staff General Association, the Mass Transit Railway Corporation Staff Union and the Staff Consultative Council, MTR Corporation, Miss CHAN Yuen-han expressed concern about the staff arrangement after privatization. Although clause 37 of the Bill provided for the vesting of the whole of the property, rights and liabilities of MTRC in the privatized Corporation and clauses 38 to 41 provided for the privatized Corporation to be treated in relation to property, etc so vested in all aspects as if it were MTRC, she considered these provisions not sufficient to safeguard the interests of employees and requested a copy of the agreement signed between the Corporation and its staff to ensure that the terms and conditions of employment-related matters would remain unchanged after privatization.

40. The Corporate Relations Manager/MTRC (CRM/MTRC) emphasized that all the terms and conditions of employment would remain unchanged after privatization. The Corporation had also notified the staff about this arrangement. However, she undertook to check whether an agreement had been signed between the Corporation and its staff on the transitional arrangements and would report the matter to the meeting. FD/MTRC said that the matter would be discussed again when the staff unions presented their views to the Bills Committee in January 2000.

MTRC

II Any other business

41. In reply to the Chairman on the schedule for passage of the bill, DS for T(1) said that the Administration expected to take one to two months to sort out the major and complicated issues arising from the privatization scheme, and would aim to resume second reading debate on the Bill as early as possible.

42. There being no other business, the meeting adjourned at 6:20 pm.

Legislative Council Secretariat
24 March 2000