

# Management Discussion & Analysis

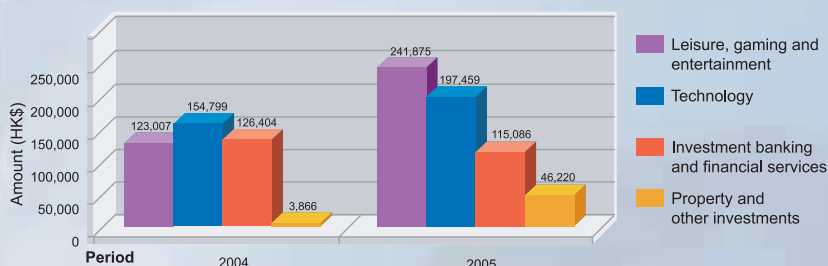
## BUSINESS REVIEW AND FINANCIAL REVIEW

Melco experienced significant growth in turnover and profitability in 2005. The Group's consolidated turnover increased to HK\$600.6 million (2004 – HK\$408.1 million), representing an increase of 47% for the year ended 31 December 2005. Net profit attributable to shareholders surged 819% to HK\$548.7 million, of which HK\$514.4 million was deemed profit upon the disposal of partial interests in Mocha Slot Group Limited ("Mocha Slot") and Great Wonders, Investments, Limited ("Great Wonders") arising from the formation of the Melco PBL joint venture.

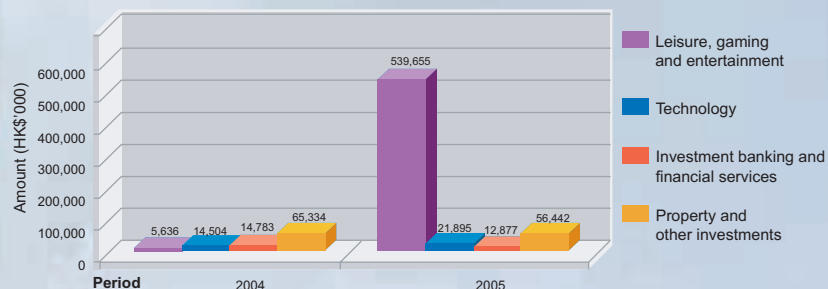
All of the Group's business divisions achieved segmental profitability during the year. These business divisions generated four main streams of segmental results including (i) Leisure, Gaming and Entertainment, (ii) Investment Banking and Financial Services, (iii) Technology and (iv) Property and Other Investments.

The contribution and growth of these four business segments during the year are illustrated below and the details are explained in this section.

Revenue Composition in Amount



Segment Results Analysis in Amount



During the year, depreciation charge increases by 99.8% to HK\$35.3 million from HK\$17.7 million in 2004. The increase was mainly due to depreciation charge on new capital expenditure incurred in new slots venues opened by Mocha Slots in 2005 plus the prudent change of depreciation rate on gaming machines from 10% p.a. to 20% p.a. effective from July 2005.

During the year, finance costs increase substantially by 6.6 times to HK\$31.7 million as compared to HK\$4.2 million in 2004. The increase was mainly attributable to the recording of the effective interest expenses on the liability component of convertible loan notes issued for material acquisitions during the year as a result of the adoption of a new accounting policy.

As at 31 December 2005, shareholders' equity amounted to HK\$3,558.2 million, with a substantial increase of 189% as compared to that of 2004.

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## LEISURE, GAMING AND ENTERTAINMENT

2005 saw exciting evolution of Macau. Opportunities continued to emerge in the gaming and entertainment industry, as value-adding facilities in casinos drew more tourists and generated more income for the gaming industry. The Group's Leisure, Gaming and Entertainment Division currently has four sub-divisions, namely, Mocha Slots, Crown Macau, The City of Dreams and Jumbo Kingdom. During the year, Mocha Slots has made a remarkable contribution to the Group's business. The Group's Crown Macau and The City of Dreams projects are progressing smoothly.

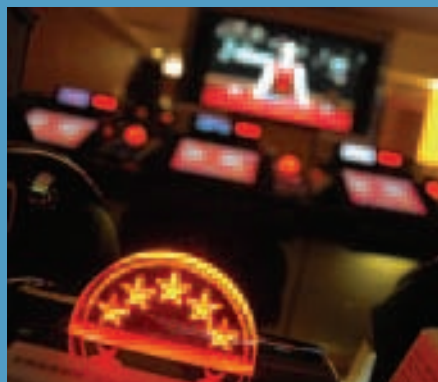
In the year under review, the Leisure, Gaming & Entertainment Division recorded a turnover of HK\$241.9 million (2004 – HK\$123 million) and segmental profit surged 95 times to HK\$539.7 million (2004 – HK\$5.6 million), of which HK\$514.4 million was deemed profit upon the disposal of partial interests in Mocha Slots and Great Wonders arising from the formation of the Melco PBL joint venture. Excluding this extraordinary gain, segmental profit of the Division still reported growth at an encouraging 348%.

### Mocha Slots

Mocha Slots focuses on the leisure grind market and is renowned as the showcase for electronic gaming in the world. Launched in 2003, Mocha Slots is an innovative spin combining the concept of slot machine parlors with a relaxing, cafe-style setting. As at 31 December 2005, the widely recognized Mocha Slots has six outlets with over 1000 machines in operation, capturing around 27% of Macau's electronic gaming market. Each Mocha Slot Hall offers a variety of themes for our valued customers. Three new Mocha Slots were opened during the year under review, including the Mocha Hotel Tapai Square, Mocha Hotel Sintra and Mocha Hotel Taipa.

Mocha Slots continued to grow and delivered an outstanding performance in 2005. During the year under review, Mocha Slots generated a total revenue of HK\$135.2 million, representing a growth of 183% (2004 – HK\$47.7 million). The average daily net win per machine stood at HK\$1,750 for 2005.

Currently, slots and electronic gaming only account for less than 5% of Macau's total gaming revenue, whereas in Las Vegas and Australia, it makes up over 50%. This indicates that electronic gaming has tremendous potential for growth in Macau. The Group is planning to open another 2 to 3 outlets in 2006, probably within or near 2-star or 3-star hotels adding approximately another 500 machines to further penetrate the market.





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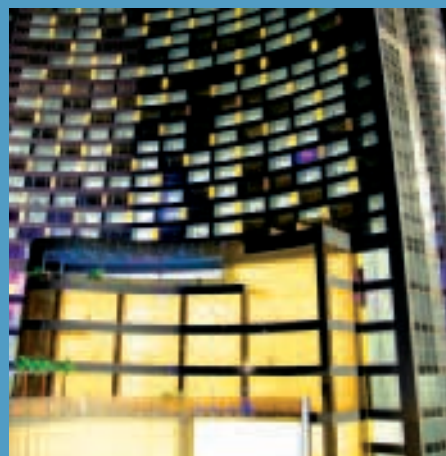
## Crown Macau

Recognizing that over 60% of Macau's gaming revenue is currently derived from VIP gaming or high limit players, Melco PBL announced in September 2004 the plan to build Crown Macau, the first 6-star luxurious casino & hotel in Taipa, which targets at global high rollers.

Crown Macau will be the most exclusive and luxurious property the market has ever seen. Standing at 160 meters, it will be the tallest building on Taipa Island. With a total construction area of 106,000 square metres, the casino-hotel will comprise deluxe VIP guest rooms, VIP suites and presidential villas. There will be a 6-storey up-market casino with a total gaming space of around 17,000 square metres, housing over 200 gaming tables and over 500 slot machines. Crown Macau will also embrace other entertainment facilities, such as elegant and unique restaurants and a deluxe spa center.

Total construction cost of this project amounts to around HK\$1.5 billion. On 13 February 2006, Melco PBL signed an agreement with a syndicate of five Macau banks and one Hong Kong bank for a HK\$1.28 billion transferable term loan facility to finance the Crown Macau project. This is the largest syndicated loan ever granted by local banks in Macau for gaming industry. It reflects the banking community's confidence in Melco and PBL and the joint venture's future development. This term loan gives the joint venture a solid capital foundation thus greater flexibility in allocating resources for future development.

The full project will be completed in the first half of 2007. As the project is still under construction, it made no contribution to the Group's financial performance in 2005.



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## The City of Dreams

In view of the promising prospect of the gaming industry, the Macau Government has launched an ambitious infrastructure development project in which a stretch of reclaimed land called Cotai would be developed into the “Las Vegas of the East”. The Cotai Strip is about one quarter the size of Macau. With high accessibility, the area has attracted substantial investment from the world’s biggest gaming operators.

The Group announced the development of a premium integrated entertainment resort – The City of Dreams – in May 2005. The City of Dreams, a first-of-its-kind integrated entertainment resort ever seen in the Asia Pacific Region, houses a variety of luxurious resort accommodations and top-notch facilities in a world of wonder. The City of Dreams serenely floats above a crystal lake, providing no less than 2,000 rooms from unique boutique hotels and themed time-sharing serviced apartments. The 72,000 square meter casino features world-class gaming facilities in a tropical underwater environment housing over 450 gaming tables and around 3,000 slot machines. The resort offers various fine dining and entertainment experiences, ranging from the underwater restaurant pavilion, the hippest clubbing nightspot, to the architecturally thrilling performance hall, which will be the iconic landmark of the Cotai Strip. Shoppers will find themselves among the latest brand name retailers, while business travelers will have easy access to the full-serviced conferencing facilities. The fitness and spa facilities will cater to people of all ages.

The City of Dreams will be an alluring and multi-dimensional integrated resort destination that will be well received in Macau and the Greater China region.

Total construction cost of the project is estimated at HK\$8 billion. The initial design of the casino and related facilities is in good progress and the complex is expected to commence operation in the second half of 2008.

As the project is still under construction, it made no contribution to the Group financial performance in 2005.





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## **Jumbo Kingdom**

The Group has been conducting an extensive marketing campaign to promote Jumbo Kingdom after it was renovated in 2003. Patronage has been steadily increasing with turnover for 2005 increased by 23% from HK\$75.8 million in 2004 to HK\$93.2 million, and has been turned around in 2005.

Jumbo Kingdom includes the Jumbo and Tai-Pak floating restaurants in Aberdeen, Hong Kong and the newly opened Chua Lam Gourmet Kitchen in Macau. The Chua Lam Gourmet Kitchen brings together renowned restaurants from around the world to offer diverse and attractive culinary choices to customers. Located in Largo Do Senado, a popular tourist spot in Macau, the four-storey Chua Lam Gourmet Kitchen occupies an area of 24,000 square feet and includes restaurants serving special Chinese and Japanese dishes. Setting a new trend in culinary culture, it is expected to become a new dining and tourist attraction in Macau.

## **INVESTMENT BANKING AND FINANCIAL SERVICES**

For the year ended 31 December 2005, turnover of the Group's financial arm, Value Convergence Holdings Limited ("Value Convergence", Stock Code: 8101) amounted to approximately HK\$115.1 million. Segmental profit for the year ended 31 December 2005 was HK\$12.9 million.

The Group's financial arm achieved a profitable result in 2005 as a result of its relentless efforts to fortify its business. Despite low market turnover of China-related stocks during the first half of 2005 and fierce market competition, Value Convergence proactively fortified its fundamentals and grew its business during the year under review. The introduction of an asset management division has taken Value Convergence one step closer to realizing its goal of becoming a full-fledged investment bank. To leverage the positive investment environment in Macau and the Pearl River Delta region, Value Convergence is currently studying the possibility of introducing investment funds to diversify investment options for clients. An expanded product portfolio will help to boost the revenue of this segment in the long run. Looking forward, Value Convergence will forge ahead with expanding its products and geographical coverage. It will also actively pursue various initiatives, such as offering fund management services, and embark on business acquisitions beneficial to the overall growth of its business.

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## TECHNOLOGY

Headed by Elixir and iAsia, the Group's technology division recorded a turnover of HK\$197.5 million (2004 – HK\$154.8 million), representing a spectacular increase of 28%. Segmental profit after the elimination of intercompany transactions amounted to HK\$21.9 million (2004 – HK\$14.5 million).

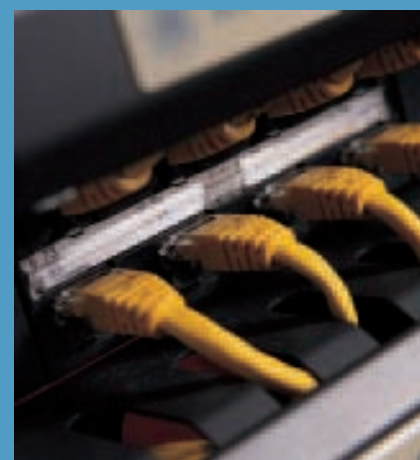
Based in Macau, Elixir has established itself as a premier gaming IT infrastructure specialist capable of offering clients a full range of system integration and network services. During the year, Elixir completed the installation of surveillance systems and slot machines for a number of new casinos opened in Macau.

The iAsia group of companies, based in Hong Kong, provides comprehensive online trading and related systems and services to financial institutions and intermediaries, principally in Asia. During the year, iAsia developed a new Bullion Deal Matching System, which has been well received in the market. The Group will continue to improve its existing online trading modules and related systems, including the new Bullion Deal Matching System, to enhance its product portfolio.

iAsia also has significant contribution to the technological sophistication of the Group's financial services unit with its IT system support services.

## PROPERTY AND OTHER INVESTMENTS

During the year, the turnover and segmental profit of this division were HK\$46.2 million (2004 – HK\$3.9 million) and HK\$56.4 million (2004 – HK\$65.3 million) respectively, owing to the increase in income from the Group's treasury function. Last year's profit was mainly attributable to the gain on disposal of an investment property of the Group in 2004, with HK\$57.2 million being recorded.





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## OUTLOOK

Macau's gaming and entertainment industry is booming with various opportunities, and value-adding entertainment facilities to casinos are bringing in an increasing number of visitors from around the world. Macau achieved a gaming revenue roughly the same as that of Las Vegas, with far fewer operators. Backed by the strong economic growth of Mainland China, the gaming market of Macau can expect exponential growth in the years to come.

In March 2006, Melco PBL sought to acquire the last casino subconcession in Macau. Subject to approval by the Government of the Macau Special Administrative Region, the subconcession will give Melco PBL the right to own and operate hotel casino resorts in Macau. With such rights, the Group will have much greater flexibility in planning and operating future projects. The purchase price payable for the acquisition of the subconcession is US\$900 million, and is anticipated to be funded as to US\$400 million by way of equity (PBL to share US\$240 million; Melco to share US\$160 million). Initially, Melco will pay only US\$40 million as deposit and the remaining 60% will be settled upon the granting of subconcession. Under the arrangement, Melco and PBL will share the economic benefit of all projects in Macau and Asia on a 50:50 basis. The subconcession will allow Melco PBL to independently operate the two proposed Macau casino projects, Crown Macau and The City of Dreams.

Subsequent to the announcement of the subconcession acquisition, the Group entered into an amicable agreement with SJM to terminate the existing slot halls operation arrangement. Melco PBL intends to continue to operate slot halls business under the subconcession. With all three gaming assets, namely, Mocha Slots, Crown Macau and The City of Dreams, covering all segments of the market, the Group will fully capitalize on the tremendous opportunities in the booming tourist industry.

Looking ahead, the Management is highly optimistic about the Group's future prospects. The Group will continue its development in Macau, with Melco PBL serving as a perfect platform to capitalize on the rising opportunities in the wider Asia region.

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## LIQUIDITY AND FINANCIAL RESOURCES/CAPITAL STRUCTURE/CHARGE ON GROUP ASSETS

The Group financed its business operations and investments with internal resources, cash revenues generated from operating activities and short-term bank loans.

As at 31st December 2005, total assets of the Group were HK\$5,581.3 million (2004 – HK\$1,584.8 million) which was financed by shareholders' fund of HK\$3,558.2 million (2004 – HK\$1,229.9 million), minority interests of HK\$629.5 million (2004 – HK\$75.6 million) and current liabilities of HK\$306.5 million (2004 – HK\$159 million) and non-current liabilities of HK\$1,087.1 million (2004 – HK\$120.4 million). The current ratio, expressed as current assets over current liabilities, of the Group was maintained at the satisfactory level of 9.4 (2004 – 5.3).

During the year ended 31 December 2005, the Group recorded a net cash inflow of HK\$1,955.3 million (2004 – HK\$252.2 million). As at 31 December 2005, cash and cash equivalents of the Group totalled at HK\$2,350.3 million (2004 – HK\$395 million). Gearing ratio, expressed as a percentage of total borrowings (including bank borrowings, obligation under finance lease, convertible loan notes and shareholder's loan) over shareholders' fund, was at a satisfactory level of 0.31 time as at 31st December 2005 (2004 – 0.15 time). The Group adopts a prudent treasury policy. The cash and bank balances consisted of about 6% cash and bank balances and 94% short term fixed deposits. All the borrowings and the majority of cash and bank balances are denominated in Hong Kong dollars to maintain minimum exposure to foreign exchange risks.

As at 31 December 2005, the Group's total available banking facilities amounted to HK\$229.8 million (2004 – HK\$224.8 million), of which HK\$80 million (2004 – HK\$70 million) were secured by margin clients listed securities, and HK\$49.8 million (2004 – HK\$49.8 million) in banking facilities were secured by pledging HK\$85 million of the Group's assets. As at 31st December 2005, the Group utilized HK\$23 million and HK\$5 million of unsecured and secured banking facilities respectively (2004 – unsecured HK\$15 million) and these amounts had matured and were repaid by 5 January 2006.

## MATERIAL ACQUISITIONS

In 2005, the Group has actively involved in several very substantial acquisitions.

Since February 2005, the Group purchased a total of 70% of Great Wonders from Sociedade de Turismo e Diversões de Macau, S.A. ("STDM") for a total consideration of HK\$156 million, which was settled by the Company's issuing two convertible loan notes to the vendor. The Group entered into a further agreement with STDM to purchase the latter's remaining 30% equity interest in Great Wonders for a consideration of HK\$400 million in March 2005. HK\$200 million of the consideration was settled in cash and the remaining HK\$200 million by the issue of 22,222,222 ordinary shares of the Company. This transaction was completed in July 2005. The principal activities of Great Wonders are to apply to the Macau Government for the concession of the land located at Taipa, Macau and to develop the land into a six-star hotel and entertainment complex with one of the largest casino and electronic gaming machine areas in Macau.

Pursuant to a Subscription Agreement dated 23 December 2004, the Company formed a joint venture with PBL in March 2005 to undertake all the gaming and hospitality business in Macau and Asia. The Company contributed 80% interests of Mocha Slots and 70% interests of Great Wonders to Melco PBL Entertainment (Greater China) Limited ("Melco PBL Entertainment"), a company owned as to 80% indirectly by Melco PBL Holdings and 20%



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indirectly by the Company, while PBL contributed HK\$1.27 billion (equivalent to US\$163 million) cash to Melco PBL Entertainment. In addition, the Company also contributed 50.8% interests of Melco Hotels to Melco PBL Entertainment.

Pursuant to an agreement signed with Great Respect Limited on 11 May 2005, Melco Leisure and Entertainment Group Limited, a wholly-owned subsidiary of the Company, acquired from Great Respect Limited the remaining 49.2% interest in a piece of land located at Taipa, on the Cotai Strip in Macau, at a consideration of HK\$1,175 million. Upon receipt of the cash consideration, Great Respect Limited then subscribed for the Company's convertible notes having a principal amount of HK\$1,175 million, which is non-interest bearing and convertible into shares in the Company. The Macau Government had on 21 April 2005 offered to Melco Hotels and Resorts (Macau) Limited, which was then an indirect wholly owned subsidiary of the Group, a medium term lease in respect of the land for development of an integrated entertainment resort

## HEADCOUNT/EMPLOYEES' INFORMATION

Coupled with our business expansion, the number of employees has increased from 710 employees as at 31 December 2004 to 842 employees as at 31 December 2005. This represents more than 18% increase and 132 new positions within the Group. Among the 842 employees, 417 are located in Hong Kong and the remaining is based in Macau and the PRC. Majority of the newly created positions are for our Macau business. The related staff costs for 2005, including Directors' emoluments and the share options expenses, amounted to HK\$137.8 million (2004: HK\$112.6 million).

Melco believes that the key to success lies in its people. We strive to create an environment that makes people proud to be a "Melco person". All of our employees are given equal opportunities for advancement and personal growth. We believe only by growing our business we create opportunities and deliver value to our people. Thus, we encourage our people to offer their best at work and grow with our business. We build staff loyalty through recognition, involvement and participation.

Melco's people policy, systems and practices are directly aligned with the Group's mission and values, and are conducive to desired behaviors, which contribute to business success.

### 1. Recruitment

Melco is an equal opportunity employer and we recruit talents with above average Professional competence, personal qualities and commitment and we hire the right people to co-shape our future. We identify and validate talents through different recruitment sources and we regularly review our recruitment structure and assessment criteria. We also employ suitable tools to assess candidates' potential.

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## 2. *Performance and Rewards*

Melco demands and appreciates high performance. Our reward principle is primarily performance based and we reward our people competitively based on their job responsibilities, performance and contribution to business results as well as professional and managerial competencies.

## 3. *Learning & Development*

Melco provides training to develop the necessary and other skills needed to satisfy business needs, which, on the one hand, would improve performance and delivered value and, on the other hand, would enhance personal growth.

We adopt a systematic approach in structuring our training programs and training programs are focused to individual and corporate needs. Training objectives would first be established with the desired outcomes clearly defined and quantified and results are continually reviewed.

## **FOREIGN EXCHANGE EXPOSURE**

It is the Group's policy for each operating entity to operate in local currencies as far as possible to minimize currency risks. The Group's principal businesses are conducted and recorded in Hong Kong dollars. Impact from foreign exchange exposure is minimal. Hence, no hedging against foreign currency exposure is necessary.

## **FUTURE PLANS FOR MATERIAL INVESTMENTS OR CAPITAL ASSETS**

On 5 March 2006, the Company entered into an Memorandum of Agreement with PBL, pursuant to which the Company agreed to make or cause to be made by its wholly-owned subsidiary to provide a loan capital contribution of US\$160 million to a company to be incorporated ("PBL Macau") to be applied towards the purchase of the Subconcession to operate gaming operations in Macau ("Subconcession") under the Subconcession Agreement entered into between Wynn Resort Limited, Wynn Resorts (Macau) S.A. and PBL at a consideration of US\$900 million.

Material capital expenditure will be incurred for the development of the projects within the joint venture with PBL in the coming years. The Company expects the respective project companies within the joint venture to arrange their required fundings as far as possible using different financing options available to them. Also, the Company will provide the required equity capital to these project companies.

## **CONTINGENT LIABILITIES**

At 31 December 2005, the Company provides guarantee of HK\$4,680,000 (2004: HK\$4,680,000) to a supplier in respect of the goods purchased by its subsidiaries.

## **CORPORATE GOVERNANCE**

During the year, the Group introduced a Code on Corporate Governance ("Code"), which sets out the corporate standards and practice used by the Group to direct and manage its business affairs. It was prepared with reference to the principles, code provisions and recommended best practices stipulated in the Code on Corporate Governance Practices issued by the Hong Kong Stock Exchange ("HKSE Code"), which came into effect on 1 January 2005. In addition to formalizing the Group's existing corporate governance principles and practices, the Code also serves to assimilate practices with benchmarks prescribed by the HKSE Code to ensure that the Group runs a highly transparent operation and is accountable to its shareholders.



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## CORPORATE RECOGNITION

During the year, the Group received a number of accolades for its outstanding business performance as well as high standard of corporate governance.

In recognition of the Group's excellent corporate governance practices, the Group's Chairman & CEO, Mr. Lawrence Ho, was awarded "Directors of the Year Award 2005" by the Hong Kong Institute of Directors. In a survey conducted by Institutional Investor, a leading global investment and capital market research and publishing organization, Mr. Ho was named the "Best CEO" in the 'Conglomerates' category. The award reviews and ranks Asian companies annually for "best practices" in investor and shareholder relations. The rankings in 2005 were based on the opinions of 227 buy-side individuals and 251 sell-side analysts from both local and international firms.

In addition, Mr. Ho was named "Leader of Tomorrow 2005" by Hong Kong Tatler. The annual award recognizes entrepreneurial spirit, leadership wisdom and traits. Mr. Ho won the award for his efforts in turning a loss-making business into an entertainment empire. Melco also received the High Flyer's Corporate Achiever Award (Leisure, Gaming and Entertainment) from the HK Business Magazine and the Top Performer Award from the South China Morning Post.

## INVESTOR RELATIONS

Melco believes that maintaining communication and transparency is vital to building good investors relations. During the year, the Group participated in numerous investor conferences organized by major international brokerages. Senior management of the Group went on non-deal roadshows regularly to other major financial centres in order to maintain constant contacts with overseas investors. In addition, site visits were regularly organized for analysts and investors to fully understand our business.

The Group places great emphasis on providing clear information to investors regarding its business strategy and direction, the progress of its projects and the industry environment in which the Group operates.



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## SOCIAL RESPONSIBILITY & ENVIRONMENTAL PROTECTION

Apart from growing its business, the Group is also committed to supporting charitable events and activities. The Melco Volunteer Team was set up in 2004 to encourage active participation in charitable causes and activities such as goodwill visits, raffle sales and fundraising campaigns in both Macau and Hong Kong.

Over the past year, Melco employees of all levels took part in a number of charitable and environmental protection events in both Hong Kong & Macau. These included:

- A Partnership Program for the Disadvantaged, co-organised with the Hong Kong Physically Handicapped and Able-bodied (HK PHAB), comprising the following activities:
  - Tuen Ng Caring Act & Visit (Jun 2005)
  - Mid Autumn Loving Party at Jumbo Kingdom (Sept 2005)
  - HK Disneyland Visit (Nov 2005)
  - Chinese New Year Caring Act & Visit (Jan 2006)
- “Greening in Melco” is a new environmental protection initiative promoting a greening culture in the Group through the following means:
  - Recycling boxes set-up in our HK & Macau offices to encourage recycling of papers, cans, and plastic bottles.
  - “Green Power Flag Day” fund raising event organized by Green Power to promote environmental protection.
  - “A Green Day At Yuen Long” organized by The Chamber of Hong Kong Listed Companies to learn about the latest technologies in environmental protection.
- Other charity visits and participation in fund raising activities included:
  - Visit the Needy (Apr 2005) organized by the Senior Citizen Home Safety Association
  - Soccer King Charity Match (Aug 2005) organized by The Community Chest
  - Visit the Methodist Epworth Village Community Centre (Oct 2005) organized by The Community Chest
  - Walk for Millions (New Territories) (Nov 2005) organized by The Community Chest
  - Walk for Millions 2005 Macau (Dec 2005)
  - The Macau Melco Fives 2006 (Feb 2006)

Through these meaningful activities, the Group hopes to nurture a sense of social responsibility among all Melco staff.

