

D. Risk factors

You should carefully consider the risks described below and other information contained in this annual report before making an investment decision. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us, or that we currently deem immaterial, may also impair our business operations. We cannot assure you that any of the events discussed in the risk factors below will not occur. If they do, our business, financial condition or results of operations could be materially adversely affected.

Risks relating to our business and operations

In light of the intense competition in our target markets, we cannot assure you that our revenues and net profit will continue to grow.

We derive our total revenues from our FTNS business and our IDD business. Our FTNS business primarily consists of broadband Internet access, local VoIP, IP-TV and corporate data services, while our IDD business primarily consists of direct dial, international calling cards and mobile call forwarding services. Our total revenues increased by 6.5% to HK\$1,574.7 million in fiscal 2010 from HK\$1,478.2 million in fiscal 2009, and our net profit increased by 1.9% to HK\$216.9 million in fiscal 2010 from HK\$212.8 million in fiscal 2009. The increase in net profit in fiscal 2010 was primarily due to increased contribution from our FTNS business and finance cost savings of HK\$32.9 million as a result of repurchase and redemption of our outstanding 10-year senior notes.

Although revenue from our FTNS business increased by 10.2% in fiscal 2010, we cannot assure you that we will be able to maintain such revenue and profit growth. The increase in revenue of our FTNS business was primarily due to an increase in our broadband subscription base of 34.5%, driven by our marketing program between November 2009 to August 2010, which lowered by approximately 50.0% our symmetric 100Mbps service to HK\$99 per month, including a Member-Get-Member promotion at this price for both the referee and referrer. Effective from September 1, 2010, we terminated such marketing program and increased the price of our residential broadband service plan from HK\$99 per month to HK\$169 per month. We cannot assure you whether our revenues and net profit will continue to grow as a result of such price increase due to intense competition in our industry. The growth of our subscription base will depend on our ability to continue to expand our network coverage and operate in a highly competitive market.

Further, revenue from our IDD business decreased by 11.6% in fiscal 2010. The decrease was primarily due to a decrease in the total number of airtime minutes by 4.7% and a decrease in our tariff rate that we are able to charge our customers. On our IDD service, our strategy is to focus on cash flow rather than market share. Due to increasing competition, we expect our IDD business will continue to experience pressure on tariff rates and to contribute to a smaller portion of our revenue and net profit over time.

Our ability to continue to grow our total revenues and net profit in the rapidly evolving telecommunications industry depends on many factors, including our ability to accurately identify and respond to demand for new services, success in developing new services on a timely basis, quality and cost competitiveness of our services, effectiveness of our sales and marketing efforts, and the number and nature of competitors in a given market segment. The global economic uncertainty has resulted in decreased consumer confidence and overall slower economic activity, which may dampen the demand for broadband services or affect our customers' ability to continue with existing services. We cannot assure you that we can maintain the current level of revenue growth and profitability.

Given the pace of change in the telecommunications industry and the characteristics of our target markets, we cannot assure you that our FTNS business will continue to be profitable.

The main target market for our FTNS business is Hong Kong. The Hong Kong telecommunications industry is highly competitive. The intense competition could result in price reductions, reduced gross margins or loss of market share, any of which could adversely affect our future growth and profitability. We expect competition to continue to increase for the following reasons:

- Increasing liberalization of the telecommunications industry in Hong Kong may continue to attract new local and foreign entrants and broaden the variety of telecommunications services available in the market, thereby increasing the overall level of competition in our industry.
- The Hong Kong government may continue to issue new wireless and wire-line FTNS Licenses. For instance, 291 PNETS Licenses had been issued in Hong Kong as of October 31, 2010 for the provision of "external telecommunications services" (as defined in the Telecommunications Authority's Determination as of December 30, 1998). Some of these licenses are held by subsidiaries of major foreign telecommunications providers, which have competitive advantages over us due to their global presence and size.
- Around December 31, 2007, Television Broadcasts Limited and Asia Television Limited, commonly known as TVB and ATV, respectively, the only two licensed domestic free television programme broadcasters in Hong Kong, launched their digital terrestrial television services and have since broadened such services to cover an increasingly large percentage of the viewing public in Hong Kong. As of December 14, 2010, their services offered a total of 11 free channels in both standard and high definition. This improvement in the quality of free television may result in a reduction in the number of subscribers for pay-television services.

As some of our main competitors have longer operating histories and others are subsidiaries of large business conglomerates, they may have greater financial, technical, marketing and other resources; a more sophisticated infrastructure; better brand recognition; and a larger subscription base and may be able to devote more human and financial resources to research and development, network improvement and marketing than we can. Our competitive position varies significantly by service type because each service is characterized by a different market. If we cannot compete effectively in a major market, our business, operating results and financial condition could be adversely affected.

Our services may become obsolete if we cannot address the changing needs of our customers.

The telecommunications industry is characterized by rapidly changing technology and industry standards, evolving subscriber needs and the changing nature of services with increasingly short life cycles. We cannot assure you that we will be able to respond successfully to technological advances and stay ahead of the evolving industry standards, for the following reasons:

- To compete successfully, we must constantly increase the diversity and sophistication of the services we offer and upgrade our telecommunications technologies. We may be required to make substantial capital expenditures and may not be successful in modifying our network infrastructure in a timely and cost-effective manner in response to these changes.
- New technology, such as the possible development of 4G wireless data networks as a substitute for fiber-based services, or other trends in the telecommunications industry, could have an adverse effect on the services we currently offer. For example, traditional fixed line home telephones are being replaced by mobile telephones and/or VoIP services. Technology substitution from global VoIP providers, some of which offer free PC-to-PC based international calls, is also becoming more prevalent. Increased adoption of such competing technology may lead to a decline in our revenues.
- Changing our services in response to market demand may require the adoption of new technologies that could render many of the technologies that we are currently implementing less competitive or obsolete. We may also need to gain access to related or enabling technologies in order to integrate the new technology with our existing technology. Our new services may contain design flaws or other defects when first introduced to the market.

If we cannot offer the new services demanded by our customers in a timely manner, our business, operating results or financial condition could be adversely affected.

The development of our Next Generation Network requires significant capital expenditures, which may not be available on terms satisfactory to us or may impose a burden on our other business activities.

Our business is capital intensive. We need to continue to devote substantial resources in infrastructure construction and upgrade to provide consistent and high quality services. In particular, because we deliver our fixed telecommunications network services through our self-owned Next Generation Network, we have made, and will continue to make, capital investments in the expansion and upgrade of this network and the development of various telecommunications services. We incurred total capital expenditures of approximately HK\$344.8 million in fiscal 2010.

We expect to incur capital expenditures ranging from approximately HK\$320 million to HK\$350 million in 2011, a large majority of which will be spent on the continued expansion and upgrade of our network. While we intend to fund such expenditures by using our currently available cash as well as cash flow from operations, we may not have adequate capital to fund our projected capital expenditures. Our ability to fund operating and capital expenditures depends significantly on our ability to generate cash from operations. In fiscal 2010, we generated cash from operating activities of HK\$485.3 million. However, we cannot assure you that we will be able to sustain our operations in order to generate sufficient cash flows to meet our future requirements. Our ability to generate cash from operations is subject to general economic, financial, industry, legal and other factors and conditions, many of which are outside our control. In particular, our operations are subject to price and demand volatility in the telecommunications industry.

If we cannot finance our operations and capital expenditure using cash generated from operations, we may be required to, among other things, incur additional debt, reduce capital expenditures, sell assets, or raise equity. The global economic uncertainty has caused a general tightening in the credit markets, lower levels of liquidity, increases in the rates of default and bankruptcy, and volatility in the capital markets. Although we have sufficient cash to meet our anticipated cash needs for at least the next 12 months, the current market conditions may affect our ability to obtain further financing to support our network expansion in the future. Any failure to do so will negatively impact our business and slow down our network deployment, in that we may not be able to continue expanding our network infrastructure to cover substantial area of the Hong Kong territory. Additional debt or equity financing may not be available, and debt financing, if available, may involve restrictions on our investing, financing and operating activities.

If any of our new services are not successful, our operating results could be adversely affected.

New telecommunications services are introduced by our competitors from time to time. If we do not anticipate these changes and rapidly adopt new and innovative services in response, we may not be able to fully capture the opportunities in the market. Development of new services, however, exposes us to the following risks:

- Developing new telecommunications services can be complex. We may not be able to adapt the new services effectively, promptly and economically to meet customer demand.

- In developing new services, we are required to continue to make significant investments in our network infrastructure in order to support these services. If we exceed our budgeted capital expenditure and cannot meet the additional capital requirements in time through operating cash flows and planned financings, we may have to delay the project.
- Any of our new services may not be commercially successful. The failure of any of our services to achieve commercial acceptance could result in additional capital expenditures or, to the extent that we are required under the applicable accounting standards to recognize a charge for the impairment of assets. Any impairment charges could materially adversely affect our financial condition and the results of our operations.

Specifically, we cannot assure you that any services enabled by upgrading and expanding our Next Generation Network will provide us with an acceptable rate of return. This would depend on our ability to accurately identify and respond to emerging consumer trends and demand. We cannot assure you that we can generate satisfactory investment returns on any new service.

We may need to improve our internal controls over financial reporting and our independent auditors may not be able to attest to their effectiveness.

The United States Securities and Exchange Commission, or the SEC, as required by Section 404(a) of the Sarbanes-Oxley Act of 2002, or the “Sarbanes-Oxley Act, adopted rules requiring every public company to include a management report on such company’s internal controls over financial reporting in its annual report, which contains management’s assessment of the effectiveness of the company’s internal controls over financial reporting. Effective from September 21, 2010, the SEC adopted amendments to its rules and forms to conform them to Section 404(c) of the Sarbanes-Oxley Act, as added by Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Section 404(c) provides that Section 404(b) of the Sarbanes-Oxley Act shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer. During fiscal 2010, we became an accelerated filer. Therefore, we are required to have an independent registered public accounting firm to attest to and report on the effectiveness of our internal controls over financial reporting starting from fiscal 2010.

We have evaluated our internal controls surrounding the financial reporting process for the current fiscal period so that management can attest to the effectiveness of these controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002. We have implemented appropriate steps to strengthen the internal controls. However, we may identify conditions that could result in significant deficiencies or material weaknesses in the future. As a result, we could experience a negative reaction in the financial markets and incur additional costs in improving the condition of our internal controls. For a detailed discussion of controls and procedures, see Item 15 “Controls and procedures.”

Notwithstanding our efforts, our management may subsequently conclude that our internal controls over financial reporting are not effective. Further, even if our management concludes that our internal controls over financial reporting are effective, our independent registered public accounting firm may conclude that our internal control over financial reporting is not effective. If we do not successfully design and implement changes to our internal controls and management systems, or if we fail to maintain the adequacy of these controls as such standards are modified or amended from time to time, we may not be able to comply with Section 404(a) of the Sarbanes-Oxley Act. This could subject us to regulatory scrutiny and penalties that may result in a loss of public confidence in our management, which could, among other things, adversely affect our customer and vendor confidence, stock price and our ability to raise additional capital and operate our business as projected.

If we cannot manage the growth in our FTNS business, the quality of our services and our operating results could be adversely affected.

We have been pursuing an aggressive strategy in growing our FTNS business. As part of this strategy, we intend to continue to expand and invest in our Next Generation Network infrastructure to support our range of broadband Internet access, local VoIP, IP-TV and corporate data services. The deployment of these projects has resulted and will result in significant demands on our systems and controls and may impact our administrative, operational and financial resources. These projects will also place significant demands on us to maintain the quality of our services to ensure that our brand does not suffer as a result of any deviations, whether actual or perceived, in the quality of our services.

Our ability to manage the growth in our FTNS business will depend upon our ability to:

- improve our existing operational, administrative and technological systems and our financial and management controls;
- enhance our infrastructure to support the expansion;
- develop effective marketing plans;
- control operational costs and maintain effective quality controls; and
- offer competitive prices to customers for our services.

Our failure to achieve any of the above in an efficient manner and at a pace consistent with the growth of our FTNS business could have an adverse effect on the quality of our services and increase our costs of operation.

We depend on certain key personnel, and our business and growth prospects may be disrupted by the loss of their services.

Our future success is dependent upon the continued service of our key executives and Talents (All individuals employed by the Group, including directors of the Company are defined as “Talents” hereafter). While we have employment agreements with members of our senior management, we cannot assure you that we will be able to retain these senior management. If one or more of our key personnel were unable or unwilling to continue in their present positions, or if they joined a competitor or formed a competing company, or if they shifted their focus away from Hong Kong operations, we may not be able to replace them easily, our business may be significantly disrupted and our financial condition and results of operations may be materially adversely affected. Furthermore, as our industry is characterized by high demand and increased competition for Talents, we may need to offer higher compensation and other benefits in order to attract and retain key personnel in the future. We cannot assure you that we will be able to attract and retain the key personnel that we will need to achieve our business objectives.

Our ability to further expand the coverage of our Next Generation Network may be limited by the physical limitations or our ability to obtain access rights in certain buildings.

Our Next Generation Network has the capability of providing value-added broadband services and content that combine voice, data and images with increased efficiency and flexibility. As part of our strategy to grow our FTNS business, we plan to increase the coverage of our Next Generation Network from the current number of 1.77 million residential homes pass as of August 31, 2010 to our target of 2.0 million residential homes pass by the end of 2011. To connect our Next Generation Network to a new physical site, we need to install fibre-to-the-home or fibre-to-the-building with Category-5e copper wiring, which we refer to as “in-building wiring”. Our expansion plan may be hindered because the installation of in-building wiring is subject to the following constraints:

- Because at least one of our competitors has already installed in-building wiring in virtually all buildings and many buildings have limited physical space for additional in-building wiring, other FTNS providers, including us, may encounter a bottleneck when installing our own in-building wiring;
- Some single-owner commercial buildings may grant rights of access to our competitors while barring us from installing our own in-building wiring; and
- Certain developers may have affiliations with our competitors and may attempt to delay or inhibit our wiring installations.

We may be unable to capitalize on any economy of scale benefits if we fail to expand our network coverage at our projected rate. Our growth opportunities will also be limited as a result.

Internet security concerns could adversely affect our Internet access services.

To remain competitive, we must continue to upgrade our broadband Internet access, local VoIP, IP-TV and corporate data services. Computer viruses, break-ins and other inappropriate or unauthorized uses of our Next Generation Network could affect the provision of our full suite of Internet Protocol services and have the following effects on our FTNS business:

- interruption, delays or cessation in services to our customers;
- a threat to the security of confidential information stored in the computer system of our customers; and
- illegal viewing or download of our contents.

To protect our business from computer viruses and other harmful attacks, we may need to incur significant costs to protect us against the threat of security breaches or to alleviate problems caused by such breaches. We intend to continue to strengthen our network security to alleviate these problems. Our efforts, however, may cause interruptions, delays or cessations of our services, and our customers may stop using our service or assert claims against us as a result.

We may be unable to further expand the scope of our Internet access services unless we obtain additional network capacity.

Our ability to transition from time to time to more advanced technologies for faster Internet access is critical to our sustainable competitiveness. Because our Next Generation Network has limited capacity, our ability to expand the network bandwidth on a timely basis is subject to the following factors:

- the expansion and development of our own international telecommunications facilities;
- the availability of leased capacity from third party carriers at favorable rates; and
- the possible termination or cancellation of our existing contracts.

If we fail to increase the capacity of our international bandwidth, our ability to increase our market share and revenue in the Internet access market segment will be limited.

Natural disasters and other disruptive regional events could damage our network and adversely affect our business and operating results.

Our network is vulnerable to damage or cessation of operations from fire, earthquakes, severe storms, heavy rainfall, power loss, telecommunications failures, network software flaws, vandalism, transmission cable cuts and other catastrophic events. We may experience failures or shut downs relating to individual points of presence or even catastrophic failure of our entire network. Any sustained failure of our network, our servers, or any link in the delivery chain, whether from operational disruption, natural disaster or otherwise, could have a material adverse effect on our business, financial condition and results of operations.

The loss of key suppliers or their failure to deliver equipment on a timely basis could negatively impact our business.

We rely on third parties for the supply of network equipment. Further, because an IP set-top-box must be installed in order to access our IP-TV services, we must have an adequate supply of such installation equipment on hand for delivery to our customers in a timely manner.

We purchase all of our IP set-top boxes and other equipment from our suppliers on a purchase order basis and have no long-term contracts. If our suppliers are unable to supply us with these products in a timely manner or the costs of these products increase due to unforeseen causes, this could negatively impact our operating results, especially if we are unable to spread the costs over a larger subscription base or effectively pass the additional costs on to our subscribers.

Because we rely on third parties in delivering services through our Next Generation Network, our operating results could be adversely affected if their services are not timely or do not meet our standards.

We depend on third parties for the ongoing maintenance and repair of our Next Generation Network. Further, although our Next Generation Network is operated essentially as an independent network, a small portion of it is connected to the network of other providers under interconnection agreements. We are also dependent on certain Hong Kong rail transport providers to maintain and provide us with access to their infrastructure to support the proper functioning of our equipment and fiber-based backbone. If these third parties fail to respond or are untimely in their response to our maintenance and repair needs, our customers may experience interruptions or variations in the quality of our fixed telecommunications network services. Any service interruptions or variations could adversely affect our operating results and our ability to retain or add new customers.

Risks relating to the regulatory, political and economic environment

Regulatory reforms and currently contemplated regulatory initiatives in the telecommunications industry may adversely affect us.

The Hong Kong telecommunications industry is undergoing continuous regulatory reform. Our business and results of operations may be adversely affected by changes in the telecommunications regulations, especially in the following areas:

- In July 2004, a new provision of the Telecommunications Ordinance came into force. This anti-competition provision specifically regulates the conduct of all carrier licensees (in particular merger and acquisition transactions) in the Hong Kong telecommunications industry by giving the Telecommunications Authority the power to review the conducts and transactions concerning carrier licensees and to take appropriate actions if it determines that the transaction would, or is likely to, prevent or substantially lessen competition in a telecommunications market. The Telecommunications Authority has the power under this provision to conduct an investigation into any questionable transaction. It might consent to the transaction (unconditionally or subject to any conditions it deems appropriate) or reject the transaction outright. The decision of the Telecommunications Authority will take into account whether the transaction will adversely affect the public interest and benefit. This provision may have an adverse effect on our ability to grow our business through mergers and acquisitions.
- We offer local VoIP services through our Next Generation Network under HKBN's FTNS License. Following the conclusion of a public consultation on the regulation of Internet Protocol Telephony Services, the Telecommunications Authority issued a statement on June 20, 2005, setting out its views and decisions on the regulatory and licensing framework for the provision of VoIP services, including the creation of a licensing framework, conformance to the existing system of assigning telephone numbers, imposition of interconnection charges and establishing guidelines with respect to the quality of services.

- We offer fixed but not mobile telecommunications network services. The Telecommunications Authority has implemented a new fixed-mobile convergence licensing practice by way of the UC License. The UC License regime, which began on August 1, 2008, seeks to replace the existing four classes of carrier licenses for the provision of fixed and mobile services with a simple license. Going forward the UC License will be the only carrier license to be issued for the provision of fixed, mobile and/or converged services. Existing carrier licenses will remain effective until their expiry date. Licensees can choose to apply to convert their existing licenses to UC Licenses before then or apply for a UC License upon expiry. This regulatory change, together with the development of new technologies, may further accelerate the convergence of fixed and mobile telecommunications services, resulting in more structural competition between fixed-line and mobile telecommunications operators. As we do not have a mobile license, and are not currently authorized to provide mobile services, our ability to compete may be hindered by our inability to offer such services independently.
- We provide our IP-TV services over our Next Generation Network under HKBN's FTNS License. The Hong Kong government has indicated that because our IP-TV services are carried over the Internet, we are exempted under the Broadcasting Ordinance from the requirement to obtain a domestic pay-television programme service license. However, the government's Communications and Technology Branch has informed us that the government is considering a review of the broadcasting regulatory regime and may introduce changes to the existing regulatory framework, including the existing exemption in the Broadcasting Ordinance. However, we cannot predict whether the government may require us to obtain a pay-television programme service license in the future.

We require licenses from the Telecommunications Authority to provide our services. If one of these licenses is revoked or not renewed or there are substantial changes in its terms and conditions, we may be unable to deliver the services authorized by that license.

We require licenses from the Telecommunications Authority to provide our fixed telecommunications network and international telecommunications services. Our business operations therefore are susceptible to the following changes in the regulatory environment in particular:

- Our ability to adjust the tariffs for different services are governed by the terms and conditions of the relevant licenses. The licenses, however, are issued under different regulatory frameworks. The differences in regulatory structure for these licenses may constrain our flexibility to respond to market conditions, competition or cost structure.
- We have been granted a waiver by the Telecommunications Authority to comply with the tariff restrictions contained in HKBN's FTNS License. If the waiver is revoked, our ability to adjust the tariffs for our fixed telecommunication network services, including our offer of discounts to subscribers from time to time, will be restricted.
- Our PNETS License is subject to the Telecommunications Authority's annual renewal. On October 19, 2009, the Telecommunications Authority announced the replacement of the PNETS License by a new class of Services-Based Operator License, Class 3 Modified Services-Based Operator License. On November 10, 2009, the PNETS License of City Telecom was replaced by a Class 3 Modified Services-Based Operator License. It is noted that the PNETS License of HKBN would also be replaced by a Class 3 Modified Services-Based Operator License on December 7, 2009 through the renewal procedure. HKBN's FTNS License was initially granted in 2000 for a term of 15 years and may be renewed for such further period not exceeding 15 years at the discretion of the Telecommunications Authority.
- The Telecommunications Authority's failure to renew or its revocation of any of these licenses or its amendment of any of the terms and conditions contained in such licenses for any reason would prohibit us from continuing to offer the services authorized by those licenses, which would have a significant adverse impact on our revenues and profitability. In addition, there may be future changes in Hong Kong's telecommunications regulations or policies that would require us to obtain additional licenses, which could have an adverse impact on our operations.

Our international telecommunications revenues may be adversely affected by increases in carrier charges in China.

In China, tariffs for all domestic and international long distance services offered through public switched telephone networks, leased lines and data services are jointly set by the Ministry of Information Industry of the PRC and the State Development Planning Commission. Certain tariffs payable by us to our carrier partners are based, among other things, on the tariffs set by these agencies with respect to the calls our subscribers make to persons in China. In fiscal 2010, approximately 79% of our international call traffic volume was to China. We cannot predict the timing, likelihood or magnitude of any tariff adjustments that may be imposed by the Ministry of Information Industry of the PRC and the State Development Planning Commission, nor can we predict the extent or potential impact upon our business of any future tariff increases. Such increases may lead to a decrease in traffic, reduce our revenues and adversely affect our business and results of operations. In addition, if we are unable to effectively manage the increased network costs, the profit margins of our IDD business could be adversely affected.

As approximately 50% of our Talents are located in Guangzhou, China, changes in Chinese labor or business laws may significantly affect our operations and our ability to serve our Hong Kong based customers.

Our call center in Guangzhou employs over 1,600 Talents and is an important resource to us. We are therefore significantly affected by the laws and regulations governing foreign companies with operations in China. As the Chinese legal system develops, changes in such laws and regulations, their interpretation or their enforcement may lead to restrictions on our ability to hire and retain our Talents in China, which could impact our ability to provide services to our Hong Kong-based customers.