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

We have substantially less financial and human resources to apply to the development of our business than some of our main competitors.

The telecommunications and pay-TV markets in Hong Kong are highly competitive. Our main competitors for Internet access, local telephony, pay-TV and international telecommunications services are PCCW-HKT Telephone Limited, or PCCW-HKT, Hutchison Global Communications Limited, or HGC, New World Telecom Company Limited, or New World, Wharf T&T Limited, or Wharf T&T, and i-Cable Communications Limited, or i-Cable. PCCW-HKT (then Hong Kong Telephone Company Limited) held a monopoly on local telephony services until 1995 when the Hong Kong government began to introduce competition to this market. In addition, i-Cable (through its subsidiary Hong Kong Cable Television Limited) was the first company to offer pay-TV services in Hong Kong beginning in 1993 and held an effective monopoly until 2003 when we and PCCW-HKT (through its subsidiary PCCW-IMS Limited) began to offer pay-TV services.

As a result of their longer operating histories, and because some of our competitors are subsidiaries of large business conglomerates, they may have advantages over us in the provision of telecommunications services, including:

- greater financial, technical, marketing and other resources;
- greater existing infrastructure;
- greater name recognition; and
- larger customer bases.

In addition, certain areas of the fixed telecommunications network services business are very capital intensive. Our competitors may be able to devote more human and financial resources to research and development, network improvement and marketing than we can. Since our inception, the growth of our market share has depended primarily on our ability to react more quickly to changes in new technology and consumer trends, offer more competitively priced services, and provide better customer support than our competitors. We cannot assure you that we will continue to be successful at executing this strategy. If these competitors devote substantial human and financial resources to their businesses, it could hurt our ability to remain competitive in the quality and range of services we could provide and we could lose customers to these competitors. This may limit the growth of our customer base, reduce our revenues and adversely affect our profits.

Our growth and profitability could be affected by an increasing number of local and foreign entrants in the international and local telecommunications and Internet access markets.

The Hong Kong government has adopted policies and regulations over the past decade to liberalize the telecommunications industry in Hong Kong, including issuing new wireless and wire-line fixed telecommunications network services licenses, which we refer to as FTNS Licenses. We expect the Hong Kong government to continue to take actions of these types over the next several years. Further, in contrast to its previous requirements when issuing network licenses, new licensees are no longer required to give any commitment relating to network rollout or investment. There are currently eight other fixed telecommunications network operators in Hong Kong in addition to ourselves who are licensed to provide local wireline-based fixed line services. These operators are PCCW-HKT, HGC, New World, Wharf T&T, Towngas Telecommunications Fixed Network Limited, CM Tel (HK) Limited, TraxComm Limited and HKC Network Limited. In addition, as of November 3, 2004, 230 public non-exclusive telecommunications service licenses, which we refer to as PNETS Licenses, for the provision of external telecommunications service had been issued to various operators in Hong Kong. Some of these licensees are subsidiaries of major foreign telecommunications providers.

Increasing liberalization of the telecommunications market in Hong Kong may further attract new local and foreign entrants to the market and broaden the variety of telecommunications services supplied by existing service providers, thereby heightening the level of competition in the industry. Increased 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.

The markets in which we compete may become more competitive should there be significant mergers and acquisitions in the Hong Kong telecommunications market.

Some of our competitors with greater financial resources may attempt to grow their customer base and product offerings through acquisitions. If these competitors make significant acquisitions, they may have increased capacity and may be better positioned to increase their market share by decreasing prices. Additionally, as a result of such acquisitions, these competitors may be able to provide a broader array of services. If we are unable to grow our business through our continued expansion or by pursuing our own acquisitions, we may have difficulties competing successfully against these competitors.

On January 20, 2005, PCCW Limited (“PCCW”) announced it had formed a strategic business alliance with China Network Communications Group Corporation, or China Netcom, one of China’s major telecommunications companies. Under this alliance, China Netcom will pay approximately US$1.0 billion in cash for newly issued PCCW shares, resulting in its holding 20% of PCCW’s share capital. This transaction may have many affects on the telecommunications market in Hong Kong, which are difficult to predict. In particular, it could result in increased competition for us and other Hong Kong telecommunications companies if PCCW is able to combine its size and market position with the increased capital provided by China Netcom to decrease prices. Furthermore, such a transaction might allow PCCW to invest more capital and human resources in its other fixed telecommunications network services that directly compete with our services.

We experienced a decline in total revenues and profits in fiscal 2004 due to a decline in revenues and profits from our international telecommunications services business. We cannot assure you that we will be able to prevent total revenues and profits from continuing to decline.

In fiscal 2004, our total revenue dropped by 9.9% from HK$1,298.9 million in fiscal 2003 to HK$1,169.9 million, due to a significant drop in revenue from our international telecommunications services. In addition, our operating profits for this business declined by 52.3% from HK$338.9 million in fiscal 2003 to HK$161.5 million in fiscal 2004. Though our international call traffic increased in terms of total number of minutes carried, this was offset by the drop in average tariff rates resulting in a decrease in revenue and operating profits. With the drop in average tariff rates, we expect that the profit margins in the international telecommunications services will continue to be under pressure. To maintain our market share, we must continue to offer our subscribers international telecommunications services that are competitive with the prices offered by other market players. We therefore must continue to lower our costs of providing these services if we are to maintain our profitability in this business. We cannot be sure that we will be able to reduce our operating costs and if we fail to do so, our profits may be adversely affected. We cannot assure you that we will be able to prevent our total revenues and profits from continuing to decline.

We rely on third parties to deliver a significant portion of our international telecommunications traffic and fixed telecommunications network services. Our transmission costs could increase as a result of changes in our relationships with them.

Where we do not currently have our own infrastructure in place, we depend on our contractual relationships with, and the network infrastructure of, other local network operators and overseas telecommunications carriers in providing international telecommunications and fixed telecommunications network services to our customers. Some of these third parties are our competitors in our international telecommunications or fixed telecommunications network services, or both. In fiscal 2004, payments to our top five overseas carriers and local network operators accounted for approximately 21% of our total gross operating costs. The terms and conditions of these local and international arrangements could be subject to changes or modification upon renewal of the relevant agreements. If the terms and conditions upon renewal are less favorable or the arrangements are not renewed, the costs associated with providing our services in locations where our own infrastructure is not in place could increase significantly.

The development of our Metro Ethernet network requires significant capital expenditures. These capital expenditures may vary materially from those currently planned and may impose a burden on our financing and operating activities.

Our business is capital intensive, and our capital expenditures may not have the positive effect on our business and revenues that we expect. We have made, and will continue to make, capital investments in the expansion and upgrade of our Metro Ethernet network and the development of our telecommunications services. We incurred capital expenditures of approximately HK$392.9 million in fiscal 2004 on our Metro Ethernet infrastructure. We expect to incur total capital expenditures of approximately HK$990.0 million in fiscal 2005 and fiscal 2006, the large majority of which will be spent on the continued expansion and upgrade of our Metro Ethernet network.

While we intend to fund such expenditures by using our currently available cash as well as cashflow from operations and the net proceeds from our January 2005 offering of 8.75% senior notes due 2015, which we refer to in this annual report as the 8.75% notes, we may not have adequate capital to fund these expenditures. In addition, if we spend our existing capital faster than anticipated or our capital requirements vary materially from those currently planned, we may require additional financing sooner than we anticipate, in which case we may need to seek to raise additional capital through debt or equity financing or other means. Any such additional debt or equity financing may not be available, and debt financing, if available, may involve restrictions on our financing and operating activities. If we are unable to obtain additional financing as needed, we may be required to reduce the scope of our operations or anticipated expansion and business development.

We may not realize the benefits we expect from our investments, which may adversely impact our business.

We have made significant investments in our network infrastructure to provide the services we offer. The launch of new and commercially viable products and services is important to the success of our business. Commercial acceptance by consumers of the new services we offer may not occur at the rate or level expected, and we may not be able to successfully adapt the new services effectively and economically to meet consumers’ demand, which would limit the return from our investments. We cannot assure you that services enabled by upgrading and expanding our Metro Ethernet network will be accepted by the public to the extent required to generate an acceptable rate of return. In addition, we face the risk of unforeseen complications in the deployment of these new services, and we cannot assure you that our estimate of the necessary capital expenditure to offer such services will not be exceeded. For example, the useful life of the equipment that we employ in buildings and for our fiber-based backbone may be shorter than expected requiring further capital expenditures. We may be unable to develop and/or deploy new services according to expected schedules, and these services may not achieve commercial acceptance or be cost effective. The failure of any of our services to achieve commercial acceptance could result in additional capital expenditures or a reduction in profitability to the extent that we are required under the applicable accounting standards to recognize a charge for the impairment of assets. Any such charge could materially and adversely affect our financial condition and the results of our operations.

Because most of the services we provide through our Metro Ethernet network are still at an early stage of implementation, evaluation of our business and our prospects is difficult.

Because of the short operating history of most of our fixed telecommunications network services, our historical financial data may not provide a meaningful basis for you to evaluate us and our prospects. These services are still at an early stage of implementation, and the revenue, potential income and cash flows from these new businesses are unproven. Accordingly, evaluation of our businesses and our prospects is difficult, and we cannot give you any assurance that we will succeed in these businesses.

We are involved in several legal proceedings that, if decided unfavorably to us, could adversely affect our profitability.

We are currently involved in several legal proceedings in Hong Kong. If these proceedings are resolved in a manner adverse to us, our business and profitability may be harmed. The most significant proceedings are:

- A case brought in July 1998 in which PCCW-HKT (then Cable & Wireless HKT) alleges that certain of our business practices breached our agreements with PCCW-HKT and unlawfully interfered with their telecommunications business.

- A case brought in April 1999 in which the plaintiff alleges that one of our wholly owned subsidiaries wrongfully terminated a telecommunications service agreement between them leaving unpaid obligations to the plaintiff of approximately US$3.6 million.

- A judicial review proceeding brought in October 2004 in which PCCW-HKT and PCCW-IMS requested judicial review of the Telecommunications Authority’s decision concerning the right of network operators to provide “off-network” local voice-over-Internet-Protocol, or VOIP services, which is described in more detail below.

In each of the proceedings mentioned above, we are vigorously defending against the claims. However, we cannot predict the way that an arbitrator or a court of law will view the facts in dispute nor can we predict how any such arbitrator or court would interpret substantive points of law; therefore, we cannot predict the outcome of these proceedings.

PCCW-HKT and PCCW-IMS have brought legal proceedings against the Telecommunications Authority that, if decided unfavorably against the Telecommunications Authority, could adversely affect our ability to provide local VOIP services accessible over the broadband connections provided by other operators.

On October 11, 2004 PCCW-HKT and PCCW-IMS applied to Hong Kong’s High Court to commence judicial review proceedings against the Telecommunications Authority in which our wholly owned subsidiary Hong Kong Broadband Network Limited, or HKBN, was initially joined as an interested party. PCCW-HKT and PCCW-IMS seek judicial review of the Telecommunications Authority’s decision dated September 22, 2004 in which the Telecommunications Authority found no evidence to suggest that HKBN is acting outside the scope of its FTNS License in providing local VOIP services accessible over the broadband connections provided by other operators, or “off-network” local VOIP. We began offering off-network local VOIP services in August 2004. PCCW-HKT and PCCW-IMS seek to have the Telecommunications Authority’s decision overturned and had requested the court to grant interim orders against both the Telecommunications Authority and HKBN to prohibit HKBN from providing off-network local VOIP services. In November 2004, PCCW-HKT and PCCW-IMS withdrew their request for interim orders, but amended its original application to include HKBN as a second respondent. The proceedings of the judicial review will continue and the hearing is set for November 28, 2005.

We are a party to the judicial review proceedings and are vigorously participating in the defense against these allegations. However, we cannot predict the outcome of the judicial review and if PCCW-HKT and PCCW-IMS are successful, we may be forced to discontinue providing off-network local VOIP services. Such an outcome will not affect our ability to offer local VOIP services within our own Metro Ethernet network, but would negatively affect our off-network local VOIP business and would likely limit our ability to add new off-network local VOIP subscribers.

We are in the process of instituting changes to our internal controls and management systems in order to satisfy the requirements of Section 404 of the Sarbanes Oxley Act of 2002. Our failure to timely and successfully institute these changes and to maintain the adequacy of our internal controls could subject us to regulatory actions and may adversely affect our stock price and our ability to raise additional capital.

We are in the process of instituting changes to our internal controls and management systems to satisfy the requirements of Section 404 of the Sarbanes Oxley Act of 2002, which will require us to perform an evaluation of our internal controls over financial reporting and beginning with our Form 20-F for the fiscal year ending August 31, 2005, file annual management assessments of their effectiveness with the SEC that include a certification of our internal controls by our chairman and director of finance and a counter-certification by our independent accountants.

In order for us to meet these requirements, we will need to design procedures to document various controls and relevant testing procedures under requirements stipulated by the Public Company Accounting Oversight Board in the United States.

We have assigned an internal audit manager to oversee this compliance process, who reports to both our audit committee and senior management on a periodic basis. In addition, we have hired external consultants to perform a high-level internal control gap analysis, but we have not retained the continuous services of these consultants in the later phases of this compliance process.

For fiscal 2005, our independent accountants will be required to attest to our evaluation of internal controls over financial reporting. Unless we 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 of the Sarbanes Oxley Act of 2002. As a result, our independent accountants will be unable to certify our management’s assertion of the effectiveness of our internal controls. This could subject us to regulatory scrutiny and result in a loss of public confidence in our management, which could, among other things, adversely affect our stock price and our ability to raise additional capital.

We have recognized revenues for mobile interconnection charges that have not yet been paid to us. We may be forced to reverse or modify our recognition of these revenues if the Telecommunications Authority determines that the level of mobile interconnection charges that mobile operators are required to pay us are not at the level that we have calculated.

We are currently in dispute with various mobile telecommunications operators as to the level and effective date of interconnection charges payable to us for direct interconnection between their mobile networks and our Metro Ethernet network. The Telecommunications Authority has confirmed that mobile operators are required to pay interconnection charges to fixed network operators, including us, but most of the mobile operators have not paid any mobile interconnection charges to us since we began offering fixed telecommunications network services to them.

In fiscal 2003 and fiscal 2004, we recognized revenue in the amount of HK$6.1 million and HK$38.7 million, respectively, for interconnection charges receivable from mobile operators for the use of our Metro Ethernet network. We determined the amount of these charges based on the fully distributed cost model determined by the Telecommunications Authority to be applicable in determining the interconnection charges between fixed and mobile operators, which relies on the historical levels of mobile interconnection charges paid by mobile operators to PCCW-HKT. In August 2004, the Telecommunications Authority agreed to determine the level of interconnection charges payable to us by one of the mobile operators, but we cannot predict the outcome of the Telecommunications Authority's determination. If the level of interconnection charges determined by the Telecommunications Authority to be payable to us is lower than the revenues that we have recognized, we will be required to write-back the difference from our revenue during fiscal 2005. This could negatively affect our operating results for fiscal 2005.

Our fixed telecommunications network business has incurred losses since inception and we expect it to incur future losses.

For fiscal 2002, 2003 and 2004, we incurred operating losses of approximately HK$121.7 million, HK$62.7 million and HK$109.7 million, respectively, from our fixed telecommunications network service operations. We expect our fixed telecommunications network service business will continue to incur net losses as we expend substantial resources on developing and marketing broadband Internet access, local VOIP, IP-TV and corporate data services. We cannot assure you that we will achieve and sustain profitability in our fixed telecommunications network operations.

Our IP-TV services may not become profitable and may adversely affect our operating results.

We began to produce, market and offer IP-TV services via our Metro Ethernet network in August 2003. Our IP-TV service currently consists of a 24-hour news channel and other education and recreation channels (including children's programming) that we produce, and channels whose content we purchase from other content-providers. As we are still at an early stage of development, the business model, marketing plans, strategy, and the content we will provide are still evolving. As a result, we cannot provide any assurance that we will be able to successfully build market share in the pay-TV business or that such business will become profitable. Further, the money that we invest in providing such service could have an adverse effect on our operating results and profitability.

Our programming costs may increase in the future, which could reduce our margins if we are unable to pass that increase on to our IP-TV subscribers.

Revenue growth for our IP-TV services depend on our ability to produce or obtain programming that is both affordable and appealing to our subscribers. We produce or supplement a small amount of the programming on our channels and obtain programming from third parties for the remainder. The cost of some of our purchased programming may increase in the future as competition in the pay-TV and television services market intensifies. Such increases could potentially affect our subscriber growth more than the dominant provider as our sales efforts are focused on our offering a lower-priced pay-TV service than our existing competitors. Our inability to pass on programming cost increases to our subscribers could reduce our revenues, cash flow and operating margins. Additionally, if we are unable to purchase programming that appeals to our targeted customer base, we may not be able to add new subscribers or increase our market share.

Our growth and expansion may strain our ability to manage our operations, increase our costs of operation and adversely affect the quality of our services.

We have pursued and continue to pursue a strategy of aggressive growth in our fixed telecommunications network services business. As part of this strategy, we continue to expand and invest in the Metro Ethernet network infrastructure we use to deliver 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 place a strain on our administrative, operational and financial resources. Our ability to manage future growth will depend upon our ability to continue to:

- manage the simultaneous implementation of our infrastructure development and marketing plans;

- cope with both predictable and unforeseen problems associated with being a relatively new entrant in rapidly evolving industries;
- effectively monitor our operations so as to control costs and maintain effective quality controls; and
- offer competitive prices to customers.

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

The Office of the Telecommunications Authority has made changes to the manner in which it regulates PCCW-HKT's tariffs for residential and business direct exchange line telephone services, which may result in more competition in our markets.

In 2003, PCCW-HKT applied twice to the Telecommunications Authority for a declaration of "non-dominance" with respect to the markets for residential and business direct exchange line telephone services. In response to these applications, the Office of the Telecommunications Authority, or OFTA, issued a new fixed carrier license to PCCW-HKT on January 14, 2005. Under this new license, PCCW-HKT is not required to obtain prior approval from the Telecommunications Authority before adjusting its tariffs on residential and business direct exchange line telephone services, including moves to offer discounts and other benefits in response to price competition. We anticipate this development will increase pricing competition further in an already competitive market. Such increased competition may adversely affect our revenues and profitability.

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 employees. We also rely extensively on the services of our executive officers, including Wong Wai Kay, Ricky, our chairman, and Cheung Chi Kin, Paul, our managing director. While we have employment agreements with members of our senior management staff, we cannot assure you that we will be able to retain these executives and employees. 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, 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 and adversely affected. Furthermore, since our industry is characterized by high demand and increased competition for talent, 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.

Universal Services Contributions are reviewed and adjusted periodically by the Telecommunications Authority, which may result in our either receiving a refund from, or being required to make whole any shortfall in payments to, PCCW-HKT. These adjustments may affect our financial results.

PCCW-HKT has a universal service obligation to provide basic telephone service to any individual or entity that requests it. To compensate PCCW-HKT for the expenses of this obligation, all incoming and outgoing international calls in Hong Kong are charged a per minute fee payable to PCCW-HKT. The Telecommunications Authority periodically adjusts the amount of this fee, which is commonly referred to as the USC. In the past we have received large USC refunds, but the amounts of these refunds have declined in the past few years. We cannot predict whether we will continue to receive refunds or whether the Telecommunications Authority may determine in the future that we have underpaid the USC and require us to make whole the shortfall, if any, in payments to PCCW-HKT. Such adjustments to the USC may affect our financial results.

Expansion of our Metro Ethernet network into certain buildings and residences may be limited by physical limitations or our ability to obtain access permits.

Expanding our Metro Ethernet network coverage requires us to install fiber-to-the-building, as well as install Cat-5e copper wiring within residential and commercial buildings to reach the subscriber's premises, which we refer to as in-building-wiring. PCCW-HKT has already installed in-building-wiring in virtually all buildings, and we along with other fixed telecommunications network service providers may encounter a bottleneck when installing our own in-building-wiring because many buildings have limited physical space for additional in-building wiring. In addition, owners of certain single-owner commercial buildings may grant rights of access to our competitors while barring us from installing our own in-building-wiring. Furthermore, certain developers may have affiliations with our competitors and may attempt to delay our wiring installations. These constraints may hinder the expansion of our Metro Ethernet network and reduce our ability to add new subscribers.

Internet security concerns could limit our ability to develop revenues from Internet access services.

We intend to continue developing our broadband Internet access, local VOIP, IP-TV and corporate data services. Computer viruses, break-ins and other inappropriate or unauthorized uses of our Metro Ethernet network could affect the provision of our full suite of Internet Protocol, or IP, services. Computer viruses, break-ins or other problems could have the following effects on our fixed telecommunications network services business:

- it could result in interruption, delays or cessation in services to our customers;
- it could jeopardize the security of confidential information stored in the computer system of our customers; and
- it could result in costly litigation.

We may incur significant costs to protect us against the threat of security breaches or to alleviate problems caused by such breaches. In addition, alleviating these problems may cause interruptions, delays or cessation in service to our users, which could cause them to stop using our service or assert claims against us.

Other fixed telecommunications network operators may be able to limit the transmission of our off-network local VOIP traffic carried over their broadband network, which may limit our ability to offer this service.

Our off-network local VOIP service is dependent on the broadband Internet connections provided by other fixed telecommunications network operators. These operators may be able to limit the transmission of our off-network local VOIP traffic carried over their broadband network, which may limit our ability to offer this service.

We may be liable for information disseminated over our Internet services network which could increase our costs or cause us to discontinue certain services.

We may be required to spend substantial resources or discontinue certain services, which could have a material adverse effect on our business, operating results and financial condition, as a result of liability under Hong Kong law for dissemination of information. Hong Kong law relating to liability of Internet service providers for information carried on or disseminated through their networks is new and untested. The imposition of potential liability upon Internet service providers, such as liability for defamatory speech or copyright infringement, for materials carried on or disseminated over a network may cause us to adopt measures that may reduce our exposure to such liability.

Illegal viewing activities may affect our IP-TV subscriber growth and subscription revenue.

Our IP-TV business is dependent upon subscription revenue. We are aware that some viewers in Hong Kong use unauthorized pay-TV decoders to receive pay-TV service illegally. Manufacturers or vendors of unauthorized pay-TV decoders may overcome our digital encryption methods and if we fail to deploy appropriate and timely countermeasures in response to such activities, illegal viewing activities may occur. Such illegal viewing activities will adversely affect the growth of our IP-TV subscriber base and our subscription revenue.

We face risks associated with potential acquisitions, investments, strategic partnerships or other ventures, including whether we can identify opportunities, complete the transactions and integrate the other parties into our business.

From time to time we have had discussions with companies regarding our acquiring, investing in or partnering with their businesses, products, services or technologies, and we regularly engage in such discussions in the ordinary course of our business. We may not be able to identify suitable acquisition, investment or strategic partnership candidates, which may place us at a disadvantage if our competitors are able to grow their market share through acquisitions. If we do identify suitable candidates, we may not be able to complete those transactions on commercially acceptable terms or at all. If we acquire another company, we could have difficulty in integrating that company’s personnel, products, operations and technology. In addition, the key personnel of the acquired company may decide not to work for us. These difficulties could disrupt our ongoing business, distract our management and employees and increase our expenses.

Risks Relating to Our Technological Infrastructure

Slow system performance over our wireless and leased wireline connections could cause us to lose Internet customers to our competitors.

Our system’s performance may slow down at certain peak times, especially with respect to the transmission of multimedia content over our wireless and leased wireline connections. Our ability to increase our handling capacity, and increase the network’s performance, will depend upon:

- the successful build out of our own fiber-based backbone, and
- our ability to secure leased lines from other network operators where we do not have our own infrastructure in place.

We cannot be sure that we will be able to replace our wireless and leased wireline connections with our fiber-based backbone and increase the performance of our Internet access system. If we do not, our customers may subscribe to other Internet access services provided by our competitors.

We will be limited in our ability to continue to expand our international telecommunications business unless we obtain additional network capacity.

Our international telecommunications network has limited capacity. Our ability to continue to increase traffic volume depends on our ability to expand the network on a timely basis and add new subscriptions, which in turn is subject to:

- the expansion and development of our own international telecommunications facilities;
- the availability of leased lines 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 telecommunications network, our ability to increase our telecommunications minutes, market share and revenues will be limited.

If we are unable to stay ahead of technology trends and evolving industry standards, our services may become obsolete.

Telecommunications businesses are characterized by rapidly changing technology and industry standards, evolving subscriber needs and the introduction of new services. The continuously changing nature of these services, and their increasingly shorter life cycles require us to continually improve our performance, services and network in order to compete successfully with the services offered by our competitors. Further, new technology or trends in the telecommunications industry could have an adverse effect on the services we currently offer. For example, the replacement of traditional fixed line home telephones with mobile telephones and/or VOIP services may lead to a decline in our International telecommunications services 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. In addition, our new products and services may contain design flaws or other defects that could have a material adverse effect on our business, operating results or financial condition. To respond successfully to technological advances and emerging industry standards, we may require substantial capital expenditure and access to related or enabling technologies in order to integrate the new technology with our existing technology. We may not be successful in modifying our network infrastructure in a timely and cost-effective manner in response to these changes, which will affect our ability to continue to offer the products and services demanded by our customers.

We are vulnerable to natural disasters, and other disruptive regional events, which could cause damage to our network and result in lost revenue and perhaps lost customers.

Our network is vulnerable to damage or cessation of operations from fire, earthquakes, severe storms, power loss, telecommunications failures, network software flaws, vandalism, transmission cable cuts and other catastrophic events. We may experience failures or shutdowns relating to individual points of presence or even catastrophic failure of our entire network. Any failure of our network, our servers, or any link in the delivery chain, whether from operational disruption, natural disaster or otherwise, resulting in an interruption in our operations, 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 prospects.

We rely on Cisco Systems, Inc. and other suppliers to provide equipment, underground cables and other key components in building our Metro Ethernet network infrastructure, and on Nortel Networks Limited for VOIP equipment. In order for new subscribers to be able to access our IP-TV services, we must install an IP set-top-box in their homes. We must have an adequate supply of such equipment on hand to respond to new customer subscriptions 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 add new subscribers or pass these costs on to our customers. In addition, if Cisco Systems, Inc. is unable or is delayed in providing us with the hardware required for building our fiber-based backbone infrastructure, this could negatively impact our operating results.

Our reliance on third parties to provide maintenance and repairs for our Metro Ethernet network could adversely affect our operating results if their services are not timely or do not meet our standards.

We depend on Cisco Systems, Inc. and other third parties for ongoing support and assistance with respect to maintenance and repairs. 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 provide us the equipment we require, or 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, which may adversely affect our operating results and our ability to retain or add new customers.

Environmental factors in Hong Kong could impact our delivery of fixed telecommunications network services using wireless technology and increase our operating costs.

Wireless transmission of information is subject to environmental influences, which could impact our delivery of fixed telecommunications network services using this technology. In particular:

- Wireless technology requires an unobstructed line of sight between two linked antennas. Hong Kong is characterized by large variations in elevation and numerous tall buildings.
- Weather conditions, such as heavy rainfall, can adversely impact the transmission quality of wireless signals and necessitate shorter distances between antennas to maintain desired transmission quality. Hong Kong's weather patterns often result in heavy rainfall during certain periods of the year.

Each of these factors may cause us to either accelerate our plans to install self-owned fiber-based backbone or lease capacity on the wireline-based backbone of other fixed network operators, which may increase our operating costs.

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. In July 2003, the Hong Kong government enacted the Telecommunications (Amendment) Ordinance 2003, or the 2003 Ordinance, which specifically regulates merger and acquisition activities in the Hong Kong telecommunications industry. The 2003 Ordinance gives the Telecommunications Authority the power to review mergers and acquisitions concerning carrier licensees and to take appropriate actions when it determines that the transaction would substantially lessen market competition without any outweighing public benefits. The Telecommunications Authority also has the right to impose conditions upon or oppose mergers and acquisitions, which may have an adverse effect on our ability to grow our business through mergers and acquisitions.

On October 4, 2004, the Telecommunications Authority issued a consultation paper requesting commentary from market participants regarding regulation of Internet Protocol telephony services. The Telecommunications Authority seeks to determine whether the existing regulatory framework, which was primarily designed to govern traditional fixed line telephony services, is applicable to VOIP telephony services. Some of the regulatory issues being addressed include creating 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. As we currently offer local VOIP services, the Telecommunications Authority's final determination may subject us to further regulations that affect our operations.

Our revenues may be adversely affected by regulatory and commercial increases in tariffs mandated by the Chinese government and other international carriers.

China's Ministry of Information Industry, or the MII, and the State Development Planning Commission jointly set tariffs for all domestic and international long distance services in China using public switched telephone networks, leased lines and data services. Certain tariffs payable by us to our carrier partners are based, among other things, on the tariffs determined by these agencies with respect to the calls our subscribers make to persons in China. In November 2002, our carrier partners in China increased the termination rates payable by us to them for international long distance telephone calls into China due to the imposition by the MII of these rate increases. To cover the increased cost for terminating traffic in China, we increased the rates we charged our customers for calls into China, which represented 65% of our international traffic for fiscal 2003. This rate increase led to an immediate drop of traffic into China. Further, our market share was adversely affected, as one of our competitors did not increase the rates it charged its customers for calls into China as a result of the increased tariff.

While our carrier partners subsequently reversed this increase in termination rates in 2003, the MII may impose changes to termination rates and related tariffs in the future, which we would expect to affect the rates we charge our customers for calls into China. In addition, following the termination rate increase imposed by China’s MII, Philippines-based carriers raised their inbound termination rates and some European mobile carriers have also made such increases in recent years. Other international carriers may follow these examples. We cannot predict the timing, likelihood or magnitude of any future tariff adjustment; nor can we predict the extent or potential impact upon our business of any such 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 pass the increased cost of services onto our customers, it would have an adverse effect on our profit margins for international telecommunications services.

The Communications and Technology Branch has issued a letter stating that we are exempt from obtaining a broadcasting license to provide our IP-TV services. However, should we be required to obtain a broadcasting license for our IP-TV services and we are unable to do so, we may be forced to terminate our IP-TV service.

Unlike our competitors, who hold domestic pay-television program service licenses, we provide our IP-TV services over our Metro Ethernet 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 exempt under the Broadcasting Ordinance from the requirement to obtain a domestic pay-television program 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. Therefore, we cannot predict whether the government may require us to obtain a pay-television program service license in the future. If such license requires us to pay significant fees or imposes restrictions on our current operations, the revenues from our IP-TV business may be adversely affected or, if we are unable to obtain a pay-television program service license, we may be forced to terminate our IP-TV services.

We require licenses from the Telecommunications Authority to provide our services. If one of these licenses is revoked or not renewed, we would be unable to deliver the services authorized by that license.

We require licenses from the Telecommunications Authority to provide our international telecommunications and fixed telecommunications network services. Our PNETS License is subject to the Telecommunications Authority’s annual renewal and HKBN’s FTNS License is initially granted for a term of 15 years, which 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 for any reason would prohibit us from continuing to offer the services authorized by that license, which would have a significant adverse impact on our revenues and profitability. In addition, future changes in Hong Kong’s telecommunications regulations or policies could have an adverse impact on our operations.

There may be political risks associated with doing business in Hong Kong.

A significant part of our facilities and operations are currently located in Hong Kong. Hong Kong is a Special Administrative Region of the People’s Republic of China, with its own executive, judicial and legislative branches. Hong Kong enjoys a high degree of autonomy from China under the principle of "one country, two systems"; however, we can give no assurance that Hong Kong will continue to enjoy the same level of autonomy from China. Any intervention by the government of China in the affairs of Hong Kong, in breach of the "one country, two systems" principle, may adversely affect our revenues and our share prices.

We have more than 50% of our staff located in Guangzhou, China and changes in Chinese labor or business laws may significantly affect our operations and our ability to service our Hong Kong based customers.

Our call center in Guangzhou employs over 1,900 persons and is an important resource for us. We are therefore subject, to a significant degree, to the laws and regulations that govern foreign companies with operations in China. The Chinese legal system is based on written statutes. Prior court decisions may be noted for reference but have limited precedential value. Since 1979, the Chinese government has promulgated laws and regulations dealing with economic matters such as foreign investment, corporate organization and governance, labor, commerce, taxation and trade. However, because these laws and regulations are relatively new and because of the limited volume of published cases and their non-binding nature, interpretation and enforcement of these laws and regulations involve significant uncertainty. In addition, as the Chinese legal system develops, changes in such laws and regulations, their interpretation or their enforcement may lead to additional restrictions on our business.

You may have difficulty enforcing judgments against us or our management.

City Telecom is incorporated in Hong Kong. All of our directors and executive officers and some of the experts named in this annual report live outside the United States, principally in Hong Kong. Also, all or most of City Telecom's assets are located outside the United States. As a result, you may not be able to:

- effect service of process upon these persons within the United States, or
- enforce, against us or these persons within the United States, court judgments obtained in United States courts, including judgments relating to the federal securities laws of the United States.

There is also doubt as to whether courts in Hong Kong will enforce judgments of United States courts based only upon the civil liability provisions of the federal securities laws of the United States, or the securities laws of any state of the United States.

The state of Hong Kong's economy may affect our profitability.

As we are principally engaged in the provision of broadband Internet access, local VOIP, IP-TV, corporate data and international telecommunications services in Hong Kong, our financial position and the results of our operations will be affected by the conditions of the telecommunications, Internet access and pay-TV markets in Hong Kong, which may in turn be influenced by the general state of the Hong Kong economy, changes in the Hong Kong regulatory environment, and changes in demand and usage habits of Hong Kong consumers. We have limited control over any of these factors. The Hong Kong economy has experienced considerable volatility during the late 1990s and from 2000 to 2003, and there can be no assurance that it will not continue to do so in the future. This could adversely affect our business operations.

Fluctuations of the Hong Kong dollar may increase our operating costs.

A major portion of our operating costs is interconnection charges paid to overseas carriers for the delivery of our international calls. Substantially all of these interconnection charges are denominated in U.S. dollars or other currencies other than Hong Kong dollars. In addition, the equipment and hardware we purchase for the expansion of our Metro Ethernet network constitutes a large portion of our capital expenditure and is also denominated in U.S. dollars. Finally, payment of interest, principal and any other amounts due under the 8.75% notes issued in January 2005 will be made in U.S. dollars. However, our revenues are denominated exclusively in Hong Kong dollars. Any depreciation of the Hong Kong dollar, against the U.S. dollar or other currencies, would increase our operating costs, including our debt servicing costs, make our capital expenditure plans more expensive, and adversely affect our profitability.

In addition, the expenses that we incur in relation to our call center located in Guangzhou, China are denominated exclusively in Renminbi, the official currency of the People's Republic of China. These include the salaries that we pay to our personnel as well as various operating expenses that we incur to maintain our operations. As a result, we are exposed to a certain amount of foreign exchange risk based on fluctuations between the Hong Kong dollar and the Renminbi. If the Renminbi appreciates against the Hong Kong dollar, the amount of Hong Kong dollars we would be required to spend to maintain our call center would increase.

Fluctuations of the Hong Kong Dollar could adversely affect the value of the American depositary shares.

Our outstanding shares are listed on The Stock Exchange of Hong Kong (the "SEHK"), on which shares are quoted and traded in Hong Kong dollars. Cash dividends, if any, in respect of the shares represented by the American depositary shares will be paid to the depositary in Hong Kong dollars and then converted by the depositary into U.S. dollars, subject to certain conditions. Any depreciation of the Hong Kong dollar against the U.S. dollar would, among other things, adversely affect (i) the amounts a registered holder or beneficial owner of American depositary shares will receive from the depositary in respect of dividends, (ii) the U.S. dollar value of the proceeds which a holder would receive upon sale of the shares in Hong Kong and (iii) the secondary market price of the American depositary shares.

Risks Relating to our Securities

Our Share Price has been and may continue to be volatile.

The trading price of our shares has been, and is likely to continue to be, extremely volatile. Since our offering of our American depositary shares on November 4, 1999, the closing price of our ordinary shares on the SEHK has ranged from HK$0.420 to HK$8.950. Our share price and the price of our American depositary shares could be subject to wide fluctuations in response to a variety of factors, including, among others:

- actual or anticipated variations in our operating results;
- announcements of new services or pricing options by us or our competitors;
- changes in financial estimates by securities analysts;
- conditions or trends in the Internet and telecommunications industries;
- changes in the market valuations of companies that provide Internet and telecommunications services; and
- rumors of and announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments.

As of February 4, 2005, we had 614,073,404 shares issued and outstanding. All of the outstanding shares are freely tradable in our primary trading market, the SEHK, and can be traded in the United States in the form of American depositary shares in compliance with the holding period, volume, and manner of sale restrictions under Rule 144 under the Securities Act of 1933, as amended (if applicable). It is possible that we may issue additional shares in connection with our financing activities, acquisition activities or otherwise. Any shares that we issue will be freely tradable on the SEHK, and, depending on the circumstances of their issuance, may also be freely tradable in the U.S. public market.

Risks Related to our Indebtedness

In January 2005, we issued 8.75% notes that contain covenants limiting our financial and operating flexibility.

Covenants under the 8.75% notes that we issued in January 2005 restrict our ability to, among other things:

- pay dividends, make distributions, redeem capital stock and make certain other restricted payments or investments;
- incur additional indebtedness or issue certain equity interests;
- merge, consolidate or sell all or substantially all of our assets;
- issue or sell capital stock of some of our subsidiaries;
- sell or exchange assets or enter into new businesses;
- create any restrictions on the payment of dividends, the making of distributions, the making of loans and the transfer of assets;
- create liens on assets;
- enter into sale and lease back transactions; and
- enter into certain transactions with affiliates or related persons.

All of these limitations are subject to exceptions and qualifications specified in the indenture governing the 8.75% notes.

These restrictive covenants could limit our ability to pursue our growth plan, restrict our flexibility in planning for, or reacting to, changes in our business and industry and increase our vulnerability to general adverse economic and industry conditions. We may enter into additional Financing arrangements in the future, which could further restrict our flexibility.

We will require a significant amount of cash to service our debt.

Our ability to fund operating and capital expenditures and to service debt will depend significant on our ability to generate cash from operations. We will need to continue generating cash flows at or above current levels to meet our future debt service requirements. However, we cannot assure you that we will be able to do so.

Our ability to generate cash is subject to general economic, financial, competitive, 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 service our debt, we may be required to (among other things) reduce capital expenditures, sell assets, or raise equity. We may not be successful in taking these actions, which could cause us to default on our obligations. Further, our ability to take many of these steps may be subject to approval by future creditors in addition to holders of the 8.75% notes.

Our indebtedness could adversely affect our financial condition and prevent us from fulfilling our obligations under the 8.75% notes.

Upon the issuance of the 8.75% notes, we incurred US$125.0 million amount of indebtedness. In addition, the indenture governing the 8.75% notes does not prohibit us or our subsidiaries from incurring substantially more debt, including secured credit facility debt and other debt as long as we meet certain debt incurrence ratios (other than CTI Guangzhou Customer Services Co. Limited (“CTI Guangzhou”) and, subsequently, any other future subsidiary prohibited by applicable law, regulation or order from issuing a guarantee of the 8.75% notes, which are restricted from incurring certain indebtedness as specified in the indenture governing the 8.75% notes). The 8.75% notes and guarantees are effectively subordinated to all of our existing and future secured debt to the extent of the value of the assets securing such indebtedness and are effectively subordinated to all existing and future debt and other liabilities of non-guarantor subsidiaries, including trade payables. If new debt is added to our consolidated debt level, the related risks that we now face could intensify.

Covenants in the agreements governing debt we may incur in the future may materially restrict our operations, including our ability to incur debt, pay dividends, make certain investments and payments, and encumber or dispose of assets. In addition, financial covenants contained in agreements relating to our future debt, including those under a credit agreement, could lead to a default in the event our results of operations do not meet our plans. A default under one debt instrument may also trigger cross-defaults under our other debt instruments. An event of default under any debt instrument, if not cured or waived, could have a material adverse effect on us. Any new debt that we incur in the future could have important consequences to holders of the 8.75% notes. For example, it could:

- make it more difficult for us to satisfy our obligations with respect to the 8.75% notes;
- increase our vulnerability to general adverse economic and industry conditions;
- limit our ability to fund future working capital, capital expenditures, research and development and other general corporate requirements;
- require us to dedicate a substantial portion of our cash flows from operations to service payments on our debt;
- limit our flexibility to react to changes in our business and the industry in which we operate;
- place us at a competitive disadvantage to any of our competitors that have less debt;
- require us to meet additional financial covenants; and
- limit, along with other restrictive covenants, among other things, our ability to borrow additional funds.

We cannot assure you that our business will generate cash in an amount sufficient to enable us to service our debt, including the 8.75% notes, or to fund our other liquidity needs. In addition, we may need to refinance all or a portion of our debt, including the 8.75% notes, on or before maturity. We cannot assure you that we will be able to refinance any of our debt on commercially reasonable terms or at all.

We may not have the ability to raise the funds necessary to finance the change of control offer required by the indenture governing the 8.75% notes.

If we undergo a change of control, we must offer to buy back the 8.75% notes for a price equal to 101% of the principal amount of the 8.75% notes, plus accrued and unpaid interest, additional amounts, if any, and registration default damages, if any. Any new financing arrangement that we may enter into in the future may require repayment upon a change of control and further prohibit us from repurchasing the 8.75% notes until we first repay the new debt in full. If a change of control occurs, we cannot assure you that we will have sufficient funds to satisfy these other debt obligations and repurchase the 8.75% notes.

ITEM 4. INFORMATION ON THE COMPANY

History and Development of the Company

City Telecom (H.K.) Ltd. was incorporated in Hong Kong on May 19, 1992 under the Companies Ordinance (Chapter 32 of the laws of Hong Kong) (the “Companies Ordinance”). Our registered office is located at 13th - 16th Floors, Trans Asia Centre, 18 Kin Hong Street, Kwai Chung, Hong Kong, telephone (852) 3145-6888. Our agent for U.S. federal securities laws purposes is CT Corporation System, 111 Eighth Avenue, New York, NY 10011.

City Telecom provides international telecommunications and, through HKBN, international telecommunications, Internet access, local telephony, pay-TV and other fixed telecommunications network services in Hong Kong. We believe that one of the cornerstones of our success has been our ability to quickly expand our service offerings when changes in regulation or technology have provided us with an opportunity to do so. Some of the key events in our history and development have been:

- In November 2004, HKBN launched our “BB100” Internet access service with symmetric 100 Mbps access for the residential mass market using self-owned fiber-to-the-building and standard Cat-5e in building copper wiring.
- In August 2004, HKBN launched our off-network BB Phone services, which allows subscribers to use our local VOIP services using the broadband network of other operators.
- In July 2004, HKBN launched our corporate data services.
- In August 2003, HKBN launched our IP-TV service, which delivers video content to a television set via an IP set-top-box.
- In July 2003, we sold the entire issued share capital of City Telecom (Japan) Co., Ltd. to Takua Corporation; City Telecom (Japan) Co., Ltd. (now known as City Call Co., Ltd.) ceased to be related to our group of companies.
- In July 2002, we established a customer service call center in Guangzhou, China to provide customer acquisition and back office customer support services.
- In June 2002, we launched a new access number “0030” for our international telecommunications services, which offers international direct dialing at competitive calling rates.
- In May 2002, we started operation of our APCN 2 and Japan-U.S. undersea cables for international calls and broadband Internet access.
- In April 2002, HKBN was notified of our license upgrade from a wireless to a wireline-based FTNS License and we began upgrading our backbone to a self-owned fiber-based backbone. In that same month HKBN launched our fixed line on-network local VOIP services in Hong Kong.
- In March 2002, the Telecommunications Authority granted us a cable-based external FTNS License.
- In May 2001, the Telecommunications Authority granted us a satellite-based fixed carrier license.
- In March 2000, HKBN launched our broadband Internet access services and wireless network in Hong Kong.
- In February 2000, HKBN obtained a wireless FTNS License from the Telecommunications Authority.