

JPM-pp1

Asia Pacific Equity Research

26 May 2015

Hong Kong Exchanges & Clearing (388 HK)

Neutral

Price: HK\$293.60

22 May 2015

Price Target: HK\$285.00

PT End Date: 31 Dec 2015

New hope springing

We have held the view that the setting up of Connect is leading to higher EPS and volumes, but it will limit PE multiples as part of hope value is now crystallized ([link](#)). This is premised on no new catalyst for another 'hope value' to build up. This premise for holding a Neutral rating on HKEx is now being tested.

- **What was the 'old hope value'?** This was build-up of expectation that one day retail mainland liquidity will step in HKEx; in that way 'through train' showed a glimpse in 2007. This is now crystallized with the Connect.
- **What is the 'new hope value'?** The build-up of expectation that foreign money, mostly institutional, will use HKEx as a means of owning A-shares in a substantial manner. Since, it is rather difficult to work out the exact EPS impact from and timing of such a move, the optimism is being reflected in higher PE multiples. This is leading to another round of re-rating for the stock.
- **What are the data to track?** The key driver of new hope value will be progress of China A-share inclusion in benchmark indices. Hence, the events to look at are 9th June (post HK market close), announcement on individual QFII quota and further clarification on tax issues. Please click on [this link](#) for JPM view on China A-share inclusion in benchmark indices.
- **What are the risks around A-share inclusion?** The upside risks for HKEx, in case of A-share inclusion are straight forward – the Connect becomes an important medium for foreign investors to trade A-shares. The flipside, though, of increased access to A-shares is ability of foreign institutional investors to bypass the Connect. There are good reasons on both side of these risks, and initial stock price reaction is likely to be positive rather than negative. Accordingly, lack of inclusion in the near term can lead to reversal of some recent gains.
- **What data / news-flow are incremental?** The news on removal of aggregate Connect quota and setting up of Shenzhen-HK Connect are already discounted, and we do not see these driving the re-rating from here on.

Table 1: HKEx share price sensitivity to different volume/PE combinations

ADT		12m fwd		EPS		309		Velocity		
Assumptions	Net Profit	EPS	Sensitivity	Curr P/E	26.5	30.6	34.7	38.9	Yield	with
HK\$ mn	HK\$ mn	HK\$	%	x	-2 SD	-1 SD	Mean	+1 SD		HSI @ 28016.34
240,000	15,245	12.90	37%	24.0	342	395	448	502	3.8%	201%
230,000	14,671	12.42	32%	24.9	329	380	431	483	3.6%	192%
220,000	14,094	11.93	27%	25.9	316	365	414	464	3.5%	184%
210,000	13,515	11.44	21%	27.1	303	350	397	445	3.3%	175%
200,000	12,933	10.94	16%	28.3	290	335	380	425	3.2%	167%
190,000	12,348	10.45	11%	29.6	277	320	363	406	3.0%	159%
180,000	11,760	9.95	6%	31.1	264	305	346	387	2.9%	150%
170,000	11,169	9.45	0%	32.7	250	289	328	367	2.7%	142%
169,381	11,132	9.42	0%	32.8	250	288	327	366	2.7%	142%
160,000	10,577	8.95	-5%	34.6	237	274	311	348	2.6%	134%
150,000	9,983	8.45	-10%	36.6	224	259	294	328	2.5%	125%
140,000	9,384	7.94	-16%	39.0	210	243	276	309	2.3%	117%
130,000	8,780	7.43	-21%	41.6	197	227	258	289	2.2%	109%
120,000	8,172	6.92	-27%	44.7	183	212	240	269	2.0%	100%
110,000	7,560	6.40	-32%	48.4	169	196	222	249	1.9%	92%

Source: J.P. Morgan estimates.

Figure 1: Implied Volumes at mean Dynamic PE vs. 30 DMA Volumes at HKEx



Source: J.P. Morgan estimates, Bloomberg.

Figure 2: Dynamic PE for HKEx



Source: J.P. Morgan estimates, Bloomberg.

Investment Thesis

The full force of Connect is visible, with HK, South and North bound volumes moving up dramatically in last few days. From here, key discussion would be around steady-state volumes from all these three sources as the initial euphoria wanes. We stay with the view that the Mainland-related hope value of volume surge is now crystallized, hence the stock price will reflect higher EPS and lower multiples.

Valuation

Our Dec-15 PT of HK\$285 is based on 30.6x -1 SD dynamic P/E. At our PT, the stock would price in 12M fwd ADT of HK\$167bn, up 140% from HK\$69.5bn in FY14.

Risks to Rating and Price Target

Higher-than-expected southbound flows during the course of next year and subsequent upward revision of the quota may pose upside risks to our estimates and vice versa. Tightening of capital requirements for central counter parties poses risks to the 90% payout.

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<http://gfd-app.emea.jpmchase.net:6080/server/console/chart/?shareClassId=502062&shareClassServerId=4&chartDesignation=1&actionType=C>

Date	Rating	Share Price (HK\$)	Price Target (HK\$)
13-Oct-06	OW	57.50	70.00
14-Nov-06	OW	65.75	75.50
08-Mar-07	OW	74.10	91.00
05-Jul-07	OW	125.50	145.00
14-Nov-07	OW	226.60	258.00
01-Mar-08	OW	151.40	200.00
13-Aug-08	N	106.80	120.00
09-Dec-08	N	70.50	55.00
13-May-09	N	109.80	101.00
09-Jun-09	OW	119.50	158.00
04-Oct-10	OW	156.80	168.00
29-Feb-12	OW	144.70	166.00
18-Apr-12	N	129.50	140.00
23-Aug-12	N	106.40	125.00
16-Sep-12	OW	118.00	125.00
05-Nov-12	OW	131.50	140.00
20-Jan-13	N	149.20	150.00
27-Feb-13	N	137.80	155.00
12-Aug-13	OW	119.40	135.00
19-Feb-14	OW	123.00	140.00
05-Apr-14	OW	130.50	145.00
11-Apr-14	OW	130.90	160.00
31-Jul-14	N	171.20	185.00
16-Apr-15	N	285.20	285.00

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