

Hong Kong Exchanges & Clearing

388 HK

Target (HKD): 209.20 → 209.20

Upside: 19.0%

5 Mar price (HKD): 175.80

- 1 Buy (unchanged)
- 2 Outperform
- 3 Hold
- 4 Underperform
- 5 Sell

Its time has come

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- Now reaping the rewards of recent years' investments
- Ambitious transformation underway
- Reaffirming Buy (1)

■ What's new

HK Exchanges and Clearing (HKEx)'s FY14 net profit rose by 13% YoY to HKD5,165m and we believe it is on track to see returns on several investments made in recent years, which has led to YoY improvement in its EBITDA margin. We believe this bodes well for its earnings outlook in the coming years, and reaffirm our Buy (1) rating.

■ What's the impact

4Q14: fourth straight quarter of net-profit improvement. HKEx's 2014 net profit was in line with our estimate of HKD5,190m, and confirms that the group has started seeing returns on the various investments it has made in recent years, leading to an 184bp YoY improvement in its EBITDA margin to 70% in 2014. Compared with the trough in 4Q12, its 4Q14 net profit has risen 74.9% against a 61.2% increase in EBITDA and a 57.7% rise in revenue.

We expect 2015 to be a breakthrough year for LME. We expect the trend of HKEx's improving profitability to continue in 2015, as LME has raised its tariff

(by 62%, we estimate) and will, on our forecasts, contribute some HKD739m in net profit in 2015. We believe this is the starting point of LME's commercialisation and that LME should become a supplementary earnings driver from 2015 onwards.

Missing links found? We stick with our view that HKEx has made active investments in the past few years (eg, trading platform, IT, etc.) to prepare for the day China finally allows mutual market access to its equity market (see our 22 November 2013 report, [Missing links finally in sight?](#)). We believe this materialised on 17 November 2014 with the launch of the Shanghai HK Stock Connect, a development that could mark the beginning of a multi-year harvesting period for HKEx (see our 19 June 2014 report: [A careful step in an ambitious journey](#)).

Ambitious transformation is underway. At its results briefing, the group said it had been actively pursuing the enhancement of the Stock Connect (the extension to include Shenzhen should occur in a matter of months) to expand mutual market access to other asset classes (such as equity derivatives, fixed income, commodities and currency), which could open up new earning streams for HKEx over time, in our view.

■ What we recommend

We continue to see considerable option value in HKEx shares. We reaffirm our Buy (1) rating and 12-month target price of HKD209.20, based on an unchanged PER of 30x (HKEx's average PER since 2006) applied to our 2016E EPS. Since 23 February, we have valued HKEx's LME stake at the same 30x PER (instead of acquisition cost) as we

believe LME will prove to be an important supplementary earnings driver for HKEx from 2015 onwards. The main risk to our call: crises resulting in investing capital returning to the US and Europe.

■ How we differ

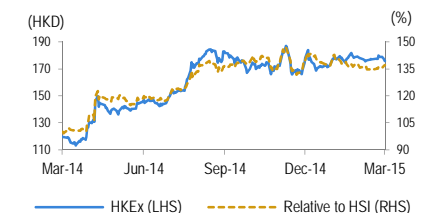
Unlike some in the market, we believe now is just the beginning of a potentially multi-year harvesting period for HKEx.

Forecast revisions (%)

Year to 31 Dec	15E	16E	17E
Revenue change	-	-	n.a.
Net profit change	-	-	n.a.
Core EPS (FD) change	-	-	n.a.

Source: Daiwa forecasts

Share price performance



12-month range	113.20-187.10
Market cap (USDbn)	26.32
3m avg daily turnover (USDm)	3,238.91
Shares outstanding (m)	1,161
Major shareholder	Government of the HK SAR (5.8%)

Financial summary (HKD)

Year to 31 Dec	15E	16E	17E
Revenue (m)	12,056	13,294	14,635
Operating profit (m)	9,009	10,104	11,254
Net profit (m)	7,186	8,018	8,932
Core EPS (fully-diluted)	6.250	6.974	7.769
EPS change (%)	39.1	11.6	11.4
Daiwa vs Cons. EPS (%)	5.8	4.4	n.a.
PER (x)	28.1	25.2	22.6
Dividend yield (%)	3.2	3.5	3.9
DPS	5.571	6.216	6.924
PBR (x)	9.3	9.0	8.6
EV/EBITDA (x)	7.4	6.3	5.4
ROE (%)	33.2	35.8	38.4

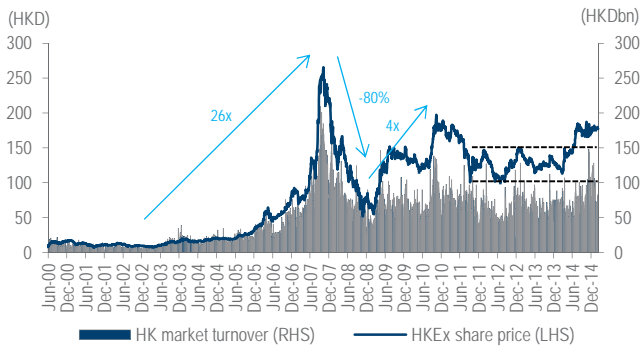
Source: FactSet, Daiwa forecasts

■ **HKEx:2014 results highlights**

	4Q13 (HKDm)	4Q14 (HKDm)	4Q14 % chg YoY	4Q14 % chg QoQ	2013 (HKDm)	2014 (HKDm)	% chg YoY
Average daily turnover (HKDbn)	59.0	80.7	+37%	+14%	62.6	69.5	+11%
Total income	2,149	2,757	+28%	+12%	8,723	9,849	+13%
Trading fees and trading tariff	860	1,039	+21%	+9%	3,509	3,760	+7%
Stock Exchange listing fees	279	282	+1%	+1%	1,016	1,102	+8%
Clearing and settlement fees	406	679	+67%	+43%	1,631	1,998	+23%
Depository, custody and nominee services fees	106	128	+21%	-41%	629	725	+15%
Market data fees	186	193	+4%	-1%	737	769	+4%
Investment income	148	182	+26%	+3%	581	707	+22%
Other income	164	254	+52%	+48%	620	788	+27%
Operating expenses	(759)	(782)	+3%	+4%	(2,777)	(2,958)	+7%
EBITDA	1,390	1,975	+42%	+15%	5,946	6,891	+16%
Depreciation and amortisation	(155)	(166)	+7%	+6%	(507)	(647)	+28%
Operating profit	1,235	1,809	+46%	+16%	5,439	6,244	+15%
Share of loss of a JV	(3)	(3)	+0%	+50%	(10)	(10)	+0%
Finance costs	(46)	(43)	-7%	-22%	(183)	(196)	+7%
Profit before tax	1,186	1,763	+49%	+17%	5,246	6,038	+15%
Tax	(168)	(260)	+55%	+17%	(700)	(900)	+29%
Minority interests	6	8	+33%	+33%		27	+350%
Net profit	1,024	1,511	+48%	+17%	4,552	5,165	+13%
Basic EPS (HKD)	0.88	1.30	+48%	+18%	3.95	4.44	+12%
DPS (HKD)	1.72	2.15	+25%	na	3.54	3.98	+12%

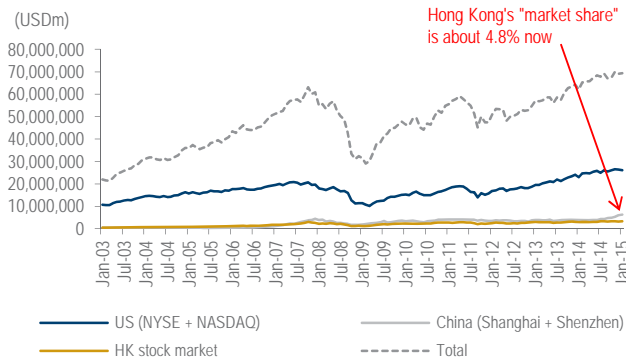
Source: Company, Daiwa

■ **HKEx: share-price trend**



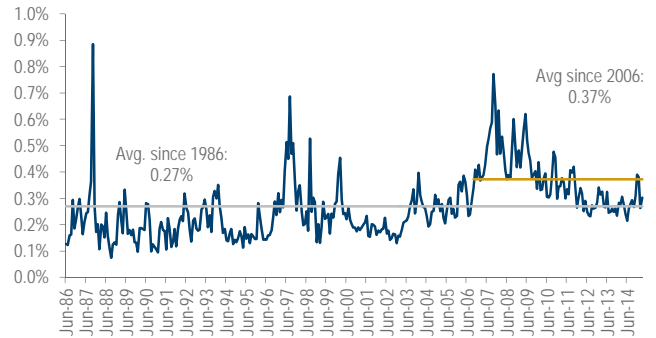
Source: Bloomberg, Daiwa

■ **Hong Kong's relative share of global stock market capitalisations**



Source: World Federation of Exchanges, Daiwa

■ **HK stock market: average daily velocity (monthly)**



Source: Bloomberg, Daiwa

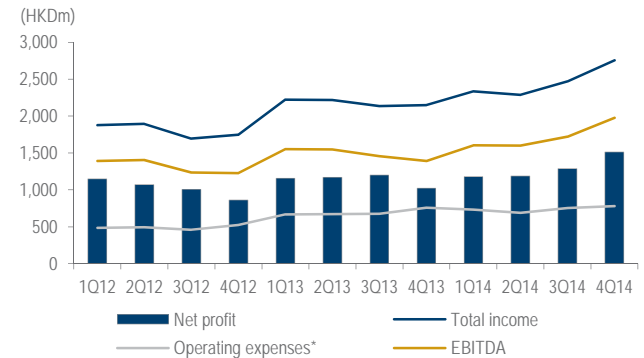
■ **Range of ADT for Hong Kong in 2015E based on historical daily velocity**

	Low	High	Average
Average daily velocity range since 2006 (monthly)	0.21%	0.77%	0.37%
Implied ADT based on HKD28tn average mkt cap in 2015E* (HKDbn)	56	216	105

Source: Bloomberg, Daiwa

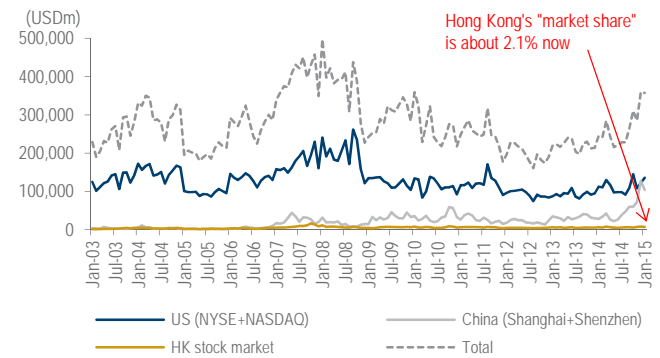
Note*Hong Kong has a market capitalisation of HKD26tn as of end-Feb 2015

■ **HKEx: quarterly KPIs**



Source: Company

■ **ADT in Hong Kong vs. turnover of stocks globally**



Source: World Federation of Exchanges, Daiwa

Financial summary

■ Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Avg. daily mkt turnover (local curr. m)	69,100	69,400	53,900	65,000	68,800	105,000	115,000	130,000
Hong Kong market cap. (HKDtn)	21	18	22	24	25	26	28	30
EBITDA-LME	n.a.	n.a.	30	539	706	1,480	1,883	2,195

■ Profit and loss (HKDm)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Trading fees and tariffs Revenues	2,843	2,936	2,718	3,350	3,760	5,649	6,427	7,258
Clearing and settlement Revenues	1,569	1,663	1,599	1,631	1,998	2,705	2,925	3,233
Other Revenue	2,682	2,758	2,128	3,150	3,369	3,702	3,942	4,144
Total Revenue	7,094	7,357	6,445	8,131	9,127	12,056	13,294	14,635
Other income	472	498	766	592	707	804	856	888
COGS	(107)	(133)	(140)	(146)	(175)	(152)	(156)	(167)
SG&A	(1,102)	(1,208)	(1,413)	(2,044)	(2,298)	(2,523)	(2,572)	(2,697)
Other op.expenses	(403)	(482)	(620)	(1,094)	(1,117)	(1,176)	(1,318)	(1,405)
Operating profit	5,954	6,032	5,038	5,439	6,244	9,009	10,104	11,254
Net-interest inc./exp.)	0	0	(55)	(183)	(196)	(231)	(258)	(262)
Assoc/forex/extraord./others	0	0	(138)	(10)	(10)	0	0	0
Pre-tax profit	5,954	6,032	4,845	5,246	6,038	8,778	9,846	10,992
Tax	(917)	(939)	(761)	(700)	(900)	(1,592)	(1,828)	(2,060)
Min. int./pref. div./others	0	0	0	6	27	0	0	0
Net profit (reported)	5,037	5,093	4,084	4,552	5,165	7,186	8,018	8,932
Net profit (adjusted)	5,037	5,093	4,084	4,552	5,165	7,186	8,018	8,932
EPS (reported)(HKD)	4.681	4.720	3.768	3.959	4.449	6.189	6.906	7.693
EPS (adjusted)(HKD)	4.681	4.720	3.768	3.959	4.449	6.189	6.906	7.693
EPS (adjusted fully-diluted)(HKD)	4.681	4.720	3.768	3.959	4.492	6.250	6.974	7.769
DPS (HKD)	4.213	4.248	3.391	3.563	3.980	5.571	6.216	6.924
EBIT	5,954	6,032	5,038	5,439	6,244	9,009	10,104	11,254
EBITDA	6,064	6,122	5,196	5,946	6,851	9,694	10,905	12,127

■ Cash flow (HKDm)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	5,954	6,032	4,845	5,246	6,038	8,778	9,846	10,992
Depreciation and amortisation	110	90	158	377	477	555	667	737
Tax paid	(945)	(980)	(761)	(700)	(900)	(1,592)	(1,828)	(2,060)
Change in working capital	514	(87)	780	2,450	426	129	138	142
Other operational CF items	50	54	111	251	266	293	322	328
Cash flow from operations	5,683	5,109	5,133	7,624	6,307	8,163	9,145	10,139
Capex	(691)	(456)	(13,819)	(1,377)	(1,228)	(1,120)	(1,060)	(1,080)
Net (acquisitions)/disposals	0	0	0	0	0	0	0	0
Other investing CF items	23	0	0	0	129,450	0	0	0
Cash flow from investing	(668)	(456)	(13,819)	(1,377)	128,222	(1,120)	(1,060)	(1,080)
Change in debt	0	0	3,900	0	0	0	0	0
Net share issues/(repurchases)	0	0	7,709	0	0	0	0	0
Dividends paid	(4,842)	(4,606)	(3,949)	(4,057)	(4,387)	(4,661)	(5,093)	(5,503)
Other financing CF items	(3,048)	348	6	0	0	0	0	0
Cash flow from financing	(7,890)	(4,258)	7,666	(4,057)	(4,387)	(4,661)	(5,093)	(5,503)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	(2,875)	395	(1,020)	2,190	130,142	2,382	2,992	3,556
Free cash flow	4,992	4,653	(8,686)	6,247	5,079	7,043	8,085	9,059

Source: FactSet, Daiwa forecasts

Financial summary continued ...

■ Balance sheet (HKDm)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	1,945	2,340	4,035	6,531	136,778	138,749	141,741	145,297
Inventory	0	0	0	0	0	0	0	0
Accounts receivable	9,203	7,210	13,696	10,946	22,523	23,538	24,128	25,080
Other current assets	34,386	42,898	42,598	47,363	72,942	73,448	74,764	75,685
Total current assets	45,534	52,448	60,329	64,840	232,243	235,735	240,633	246,062
Fixed assets	295	948	1,675	1,753	1,603	1,575	1,440	1,223
Goodwill & intangibles	0	0	18,183	18,680	17,901	18,293	17,685	17,291
Other non-current assets	2,055	632	650	670	113	698	712	750
Total assets	47,884	54,028	80,837	85,943	251,860	256,301	260,470	265,326
Short-term debt	0	0	0	0	0	0	0	0
Accounts payable	9,946	8,456	15,838	12,834	22,849	26,012	28,350	28,980
Other current liabilities	29,214	36,353	40,555	39,793	129,484	129,953	130,513	131,512
Total current liabilities	39,160	44,809	56,393	52,627	152,333	155,965	158,863	160,492
Long-term debt	0	0	6,615	6,921	7,026	6,615	6,615	6,615
Other non-current liabilities	47	60	65	5,877	71,142	71,639	72,107	74,437
Total liabilities	39,207	44,869	63,073	65,425	230,501	234,219	237,585	241,544
Share capital	1,078	1,080	1,150	1,161	12,225	12,225	12,225	12,225
Reserves/R.E./others	7,599	8,079	16,614	19,244	9,048	9,767	10,568	11,462
Shareholders' equity	8,677	9,159	17,764	20,405	21,273	21,992	22,793	23,687
Minority interests	0	0	0	113	86	90	92	95
Total equity & liabilities	47,884	54,028	80,837	85,943	251,860	256,301	260,470	265,326
EV	202,159	201,764	206,684	204,607	74,438	72,060	69,070	65,517
Net debt/(cash)	(1,945)	(2,340)	2,580	390	(129,752)	(132,134)	(135,126)	(138,682)
BVPS (HKD)	8.064	8.488	16.463	17.747	18.323	18.942	19.633	20.402

■ Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	10.6	3.7	(12.4)	26.2	12.2	32.1	10.3	10.1
EBITDA (YoY)	7.5	1.0	(15.1)	14.4	15.2	41.5	12.5	11.2
Operating profit (YoY)	7.4	1.3	(16.5)	8.0	14.8	44.3	12.2	11.4
Net profit (YoY)	7.1	1.1	(19.8)	11.5	13.5	39.1	11.6	11.4
Core EPS (fully-diluted) (YoY)	7.1	0.8	(20.2)	5.1	13.5	39.1	11.6	11.4
Gross-profit margin	98.5	98.2	97.8	98.2	98.1	98.7	98.8	98.9
EBITDA margin	85.5	83.2	80.6	73.1	75.1	80.4	82.0	82.9
Operating-profit margin	83.9	82.0	78.2	66.9	68.4	74.7	76.0	76.9
Net profit margin	71.0	69.2	63.4	56.0	56.6	59.6	60.3	61.0
ROAE	60.3	57.1	30.3	23.9	24.8	33.2	35.8	38.4
ROAA	10.8	10.0	6.1	5.5	3.1	2.8	3.1	3.4
ROCE	71.3	67.6	30.0	21.0	22.4	31.6	34.7	37.6
ROIC	101.4	75.2	31.3	22.9	(12.1)	(6.8)	(7.4)	(8.1)
Net debt to equity	n.a.	n.a.	14.5	1.9	n.a.	n.a.	n.a.	n.a.
Effective tax rate	15.4	15.6	15.7	13.3	14.9	18.1	18.6	18.7
Accounts receivable (days)	528.3	407.1	592.0	553.1	669.2	697.3	654.4	613.6
Current ratio (x)	1.2	1.2	1.1	1.2	1.5	1.5	1.5	1.5
Net interest cover (x)	n.a.	n.a.	91.6	29.7	31.9	39.0	39.2	43.0
Net dividend payout	90.0	90.0	90.0	90.0	89.5	90.0	90.0	90.0
Free cash flow yield	2.4	2.3	n.a.	3.1	2.5	3.5	4.0	4.4

Source: FactSet, Daiwa forecasts

■ Company profile

HK Exchanges & Clearing (HKEx) owns and operates the only stock exchange and futures exchange in Hong Kong and the related clearing houses. The company was formed in 2000 as a result of a merger between the Stock Exchange of Hong Kong and the Hong Kong Futures Exchange. After the merger, the company was listed on the Hong Kong Stock Exchange in June 2000.

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