

# HKEx (388 HK)

## Overweight

Target price (HKD)	200.00
Share price (HKD)	177.30
Forecast dividend yield (%)	3.2
Potential return (%)	16.0

Note: Potential return equals the percentage difference between the current share price and the target price, plus the forecast dividend yield

	2014 a	2015 e	2016 e
HSBC EPS	4.44	6.38	7.51
HSBC PE	39.9	27.8	23.6
<b>Performance</b>	<b>1M</b>	<b>3M</b>	<b>12M</b>
Absolute (%)	-0.6	1.4	48.0
Relative <sup>A</sup> (%)	0.3	-1.2	37.1

Note: (V) = volatile (please see disclosure appendix)

5 March 2015

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## Disclaimer & Disclosures

This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

OW: Outlook is turning even more favourable on two trends

- ▶ **4Q14 profit was up 48% y-o-y, due to improved market turnover and higher LME income**
- ▶ **Profit growth is set to continue in 2015. Longer-term outlook is well supported by China's monetary easing and capital outflow**
- ▶ **Reiterate Overweight rating and HKD200 target price**

**4Q14 results underline strong near-term growth:** HKEx has reported its profit was up 48% y-o-y to HKD1.5bn in 4Q14, driven by higher market turnover, full quarterly consolidation of LME Clear and revenue related to the Shanghai Hong Kong Stock Connect (SHSC). HKEx says the SHSC, which was launched on 17 November 2014, made around a HKD68m revenue contribution in 2014. On a full-year basis, HKEx's profit was up 13% y-o-y to HKD5.2bn, which is the highest level since 2007.

**Riding on two key trends:** We forecast HKEx's profit to grow 44% in 2015 on the higher stock turnover and greater profit contribution from LME. Although this is becoming more widely expected, we think the market has not yet fully taken into account the solid growth outlook for HKEx, which is turning even more favourable with two key trends:

- ▶ **China's monetary easing:** Since last November, PBOC has cut the interest rate and RRR and these, in our view, are only part of the country's easing packages. This has led to a significant rise in the domestic A-share market's turnover, which used to be highly correlated with the stock turnover in Hong Kong.
- ▶ **Increasing capital outflow from China:** China has become a net "capital exporter" in 2014, according to the Ministry of Commerce. Our economists expect this trend to continue (see [China Inside Out](#), published on 10 February 2015) and we believe HKEx should benefit given Hong Kong's role as a gateway to China's inward and outward direct investment, as well as the growing liquidity of offshore RMB, which will in turn support the further expansion of the mainland connectivity.

**Revised forecasts:** We have increased our ADT forecasts for 2015 and 2016, which offsets our lower forecasts for the SHSC and derivatives business, leading our profit forecasts to be barely changed for 2015e and 2016e. Our target price is unchanged at HKD200, based on our three-stage residual income valuation, and implies 31x 2015e PE; we maintain our Overweight rating.

Key downside risks include unfavourable changes to market, regulations and policies, and operating risks in new business.

Index <sup>A</sup>	Hang Seng Index
Index level	24,465
RIC	0388.HK
Bloomberg	388 HK

Source: HSBC

Enterprise value	213,642
Free float (%)	94
Market cap (USDm)	26,489
Market cap (HKDm)	206,616

Source: HSBC

## Financials & valuation: Hong Kong Exchanges & Clearing Limited

Overweight

### Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>P&amp;L summary (HKDm)</b>				
Total revenue	9,849	13,033	15,024	17,211
Trading fees and trading tariff	3,760	5,298	6,232	7,062
Clearing and settlement fees	1,998	3,098	3,602	4,452
Depository related	725	851	988	1,097
Listing fees	1,102	1,194	1,260	1,317
Market data fees	769	817	879	948
Net investment income	707	921	1,127	1,319
Other income	788	855	936	1,016
Total expenses	(3,801)	(4,129)	(4,325)	(4,531)
Staff related expenses	(1,716)	(1,995)	(2,129)	(2,265)
IT related expenses	(510)	(568)	(620)	(664)
Depreciation and amortization	(647)	(625)	(612)	(599)
Finance costs	(196)	(197)	(211)	(211)
Other expenses	(732)	(744)	(754)	(792)
Operating profit	6,048	8,905	10,699	12,680
Non-operating profit/loss	(10)	9	9	9
Pre-tax profit	6,038	8,914	10,708	12,689
Tax	(900)	(1,475)	(1,726)	(2,015)
Non-controlling interest	(27)	0	0	0
Net profit	5,165	7,439	8,982	10,674
EBITDA	6,891	9,727	11,522	13,490

### Balance sheet summary (HKDm)

Total assets	251,860	263,327	286,332	303,388
AR, prepayment and deposits	22,523	16,975	19,521	21,474
Margin funds	128,869	139,624	152,835	164,639
Clearing house funds	10,289	11,471	12,599	13,570
Corporate funds	10,264	11,407	12,976	14,730
Cash mark and collateral	619	671	734	791
Goodwill	13,750	13,750	13,750	13,750
Others	65,546	69,428	73,915	74,435
Total liabilities	230,501	241,183	263,249	279,196
Margin deposits on derivatives	128,865	139,624	152,835	164,639
AP, accruals & other liabilities	22,849	18,673	21,474	19,326
Clearinghouse fund contribution	9,426	10,553	11,717	12,755
Borrowings	7,026	7,026	7,026	7,026
Other liabilities	62,335	65,306	70,197	75,449
Shareholders' equity	21,273	22,058	22,997	24,105

### Per share data (HKD)

EPS (basic)	4.44	6.38	7.51	8.71
EPS (diluted)	4.43	6.31	7.42	8.58
DPS	3.98	5.74	6.76	7.84
NAV	18.26	18.53	18.84	19.26

### ROAA deconstruction

Total revenue	5.8%	5.1%	5.5%	5.8%
Total expenses	-2.3%	-1.6%	-1.6%	-1.5%
Operating profit	3.6%	3.5%	3.9%	4.3%
Non-operating profit	-	-	-	-
Profits before tax	3.6%	3.5%	3.9%	4.3%
Tax	-0.5%	-0.6%	-0.6%	-0.7%
Net profit	3.1%	2.9%	3.3%	3.6%

### Valuation

Year to	12/2014a	12/2015e	12/2016e	12/2017e
PE	39.9	27.8	23.6	20.4
PB	9.7	9.6	9.4	9.2
Dividend yield	2.2%	3.2%	3.8%	4.4%

### Growth rates (y-o-y)

Total revenue	14.3%	32.3%	15.3%	14.6%
Total expenses	9.6%	8.6%	4.8%	4.8%
Operating profit	17.4%	47.2%	20.1%	18.5%
Net profit	13.5%	44.0%	20.7%	18.8%
EPS	12.4%	43.8%	17.7%	15.9%
Total assets	193.1%	4.6%	8.7%	6.0%
Shareholders' equity	4.3%	3.7%	4.3%	4.8%

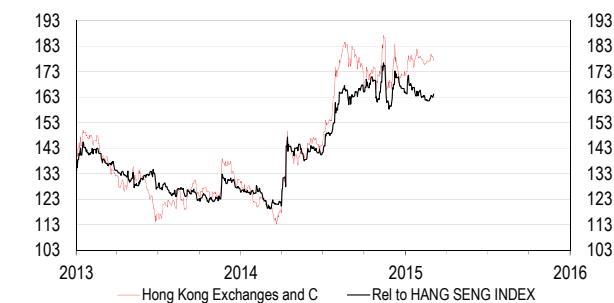
### Key drivers and ratios

Cash ADT(HKDm, ex-Southbound)	69,456	84,876	97,607	107,368
ADT (derivatives, contracts)	576,676	679,456	760,991	821,870
Southbound ADT (RMBm)	NA	3,150	8,400	12,600
Northbound ADT(RMBm)	NA	6,500	13,000	19,500
Net investment return	0.54%	0.42%	0.48%	0.52%
Cost to income ratio	33.6%	31.3%	29.0%	26.8%
ROA	3.1%	2.9%	3.3%	3.6%
ROE	24.8%	34.3%	39.9%	45.3%
EBITDA coverage	35.2	49.4	54.7	64.0
Gross gearing ratio	32.9%	31.7%	30.4%	29.0%

### Issuer information

Share price (HKD)	177.30	No. of shares (m)	1,165
Target price (HKD)	200.00	Market cap (HKDm)	206,616
		Bloomberg (Equity)	388 HK
Free float	94%	Reuters (Equity)	0388.HK
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### Price relative



Note: Priced at close of 5 March 2015

HKEx: Summary and comparison of the 4Q14/FY14 results (HKDm)

	4Q13	3Q14	4Q14	yoy	qoq	FY13	FY14	yoy
Trading fees and trading tariff	860	956	1,039	21%	9%	3,509	3,760	7%
Clearing and settlement fees	406	476	679	67%	43%	1,631	1,998	23%
Depository, custody & nominee	106	218	128	21%	-41%	629	725	15%
Listing fees	279	279	282	1%	1%	1,016	1,102	8%
Market data fees	186	194	193	4%	-1%	737	769	4%
Net investment income	148	172	186	26%	8%	475	707	49%
Other income	164	176	250	52%	42%	620	788	27%
Total revenue	2,149	2,471	2,757	28%	12%	8,617	9,849	14%
Staff costs and related expenses	(376)	(444)	(450)	20%	1%	(1,495)	(1,716)	15%
IT and computer maintenance expenses	(163)	(114)	(135)	-17%	18%	(549)	(510)	-7%
Depreciation and amortization	(155)	(157)	(166)	7%	6%	(507)	(647)	28%
Finance cost	(46)	(55)	(43)	NA	-22%	(183)	(196)	7%
Others	(220)	(195)	(197)	-10%	1%	(733)	(732)	0%
Total expenses	(960)	(965)	(991)	3%	3%	(3,467)	(3,801)	10%
Non-operating profit/loss	(3)	(2)	(3)	NA	50%	96	(10)	NA
Tax	(168)	(223)	(260)	55%	17%	(700)	(900)	29%
<b>Net profit</b>	<b>1,024</b>	<b>1,287</b>	<b>1,511</b>	<b>48%</b>	<b>17%</b>	<b>4,552</b>	<b>5,165</b>	<b>13%</b>
EPS (HKD)	1.00	1.10	1.30	30%	18%	3.95	4.44	12%
EBITDA	1,390	1,718	1,975	42%	15%	5,946	6,891	16%
Cash ADT (HKDbn)	59.0	70.9	80.7	37%	14%	62.6	69.5	11%
Derivatives ADT (no. of contracts)	514,398	556,968	696,281	35%	25%	535,905	576,676	8%

Source: Company data, HSBC calculations

## Results review and prospects

HKEx has reported HKD1.5bn net profit in 4Q14, up 48% y-o-y and 17% q-o-q. Key highlights include:

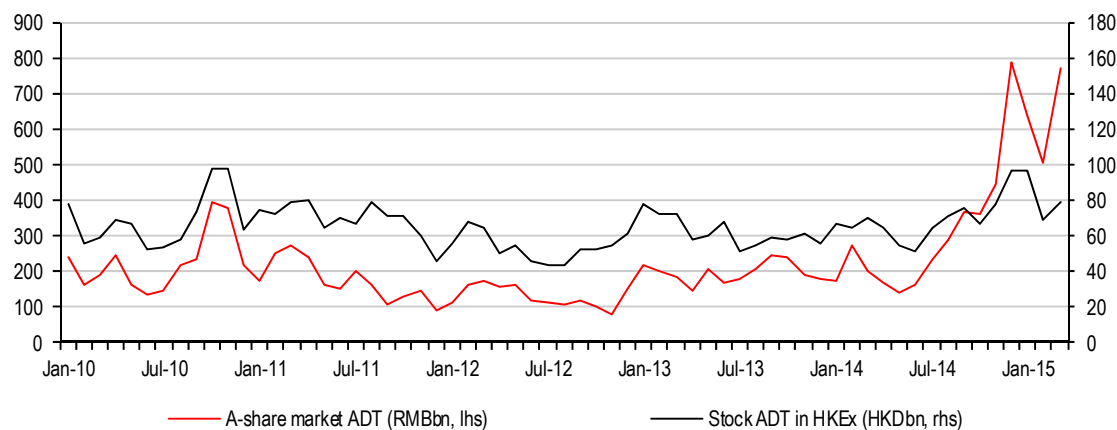
**Cash market:** During 4Q14, the cash average daily turnover (ADT) rose to HKD81bn, its highest level since 4Q10. In particular, ADT rose to nearly HKD100bn in December 2014, following the spike in the A share market's turnover. We still see plenty of room to catch up with the rally in A-share market turnover, especially in view of the benign turnover velocity of 66% in HKEx (versus its historical range of 40-160%).

**Derivatives:** Derivatives turnover (excluding LME contracts) volume was up 8% y-o-y in 2014, slightly below cash turnover growth. Nonetheless, we are optimistic about its future growth, especially since there is a possibility the HKEx could introduce the CSI 300 index future contract, a blockbuster contract with 217m turnover in 2014, to the offshore investors through expansion of the mainland connectivity.

**LME:** Unlike last year, HKEx has not separately disclosed LME's financial performance in the results, which is being segregated in both the commodities and clearing segments. Nonetheless, HKEx says LME Clear has contributed HKD187m revenue since its launch on 22 September 2014, in line with our forecast. We expect LME to be a key profit growth driver in 2015, on the back of the trading fee hike and a full-year contribution from LME Clear, contributing 24% of HKEx's 2015e revenue (from the 15% we estimated in 2014).

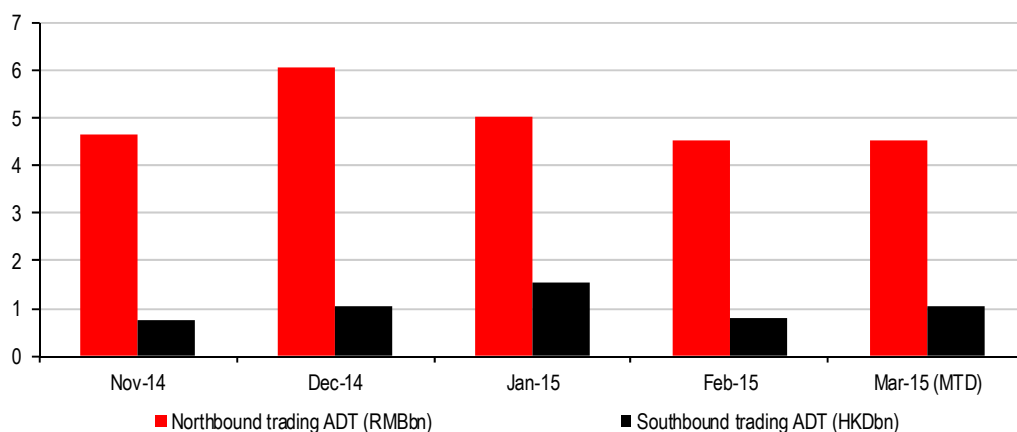
**Stock Connect:** HKEx reported the SHSC contributed HKD68m revenue during the quarter. We estimate this includes IT-related revenue (eg from network and dataline subscriptions). Although this is less than 3% of total revenue in 4Q14, it is consistent with our view that SHSC is not a near-term business driver (with only a 2% revenue contribution in 2015e). Nonetheless, the smooth launch of SHSC demonstrated the capabilities of HKEx to deliver its strategic vision and act on its business planning, giving confidence in the further expansion of the scheme. Moreover, the rising outward investment of China – spearheaded by the “one route, one belt” policy initiatives – could lead to more offshore RMB liquidity, enhancing offshore investment demand and more usage on the SHSC.

**Stock turnover in Hong Kong used to be highly correlated to China's, but has lagged behind significantly since 2H14**



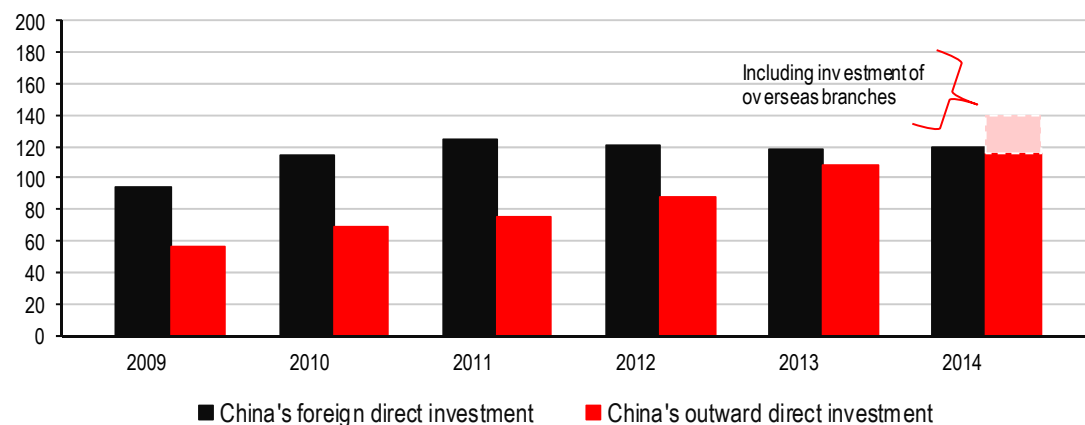
Source: Bloomberg, CEIC, HSBC calculations

**SHSC turnover has improved from launch to January 2015, but was down in February 2015, probably due to seasonal effect**



Source: HKEx, HSBC calculations

**China's ODI should have surpassed FDI in 2014, if investment made by the overseas branches of China Inc. is included (USDbn)**



Source: CEIC, HSBC calculations

**HKEx: Summary of change in forecasts (HKDm)**

Income statement	Previous forecasts		Revised forecasts		New 2017e	% Change	
	2015e	2016e	2015e	2016e		2015e	2016e
Trading fees and trading tariff	5,289	6,118	5,298	6,232	7,062	0%	2%
Clearing and settlement fees	2,988	3,498	3,098	3,602	4,452	4%	3%
Depository, custody & nominee	805	912	851	988	1,097	6%	8%
Listing fees	1,158	1,215	1,194	1,260	1,317	3%	4%
Market data fees	833	896	817	879	948	-2%	-2%
Net investment income	941	1,060	921	1,127	1,319	-2%	6%
Other income	784	875	855	936	1,016	9%	7%
Total revenue	12,797	14,573	13,033	15,024	17,211	2%	3%
Staff costs and related expenses	(1,777)	(1,904)	(1,995)	(2,129)	(2,265)	12%	12%
IT and computer maintenance	(590)	(632)	(568)	(620)	(664)	-4%	-2%
Depreciation and amortization	(625)	(612)	(625)	(612)	(599)	0%	0%
Finance cost	(187)	(187)	(197)	(211)	(211)	5%	13%
Others	(775)	(822)	(744)	(754)	(792)	-4%	-8%
Total expenses	(3,954)	(4,156)	(4,129)	(4,325)	(4,531)	4%	4%
Pre-tax profit	8,862	10,435	8,914	10,708	12,689	1%	3%
Tax	(1,428)	(1,632)	(1,475)	(1,726)	(2,015)	3%	6%
Net profit	7,434	8,804	7,439	8,982	10,674	0%	2%

Source: HSBC estimates

## Revised forecasts

We have revised our forecasts for HKEx to reflect the following changes/considerations:

- ▶ We have raised our core cash ADT estimate (excluding the SHSC impact) by 6% to HKD85bn in 2015e and 9% to HKD98bn in 2016e, to reflect the positive impact of monetary easing in China. We have raised our cost forecasts to reflect the higher revenue and operating performance.
- ▶ We have reduced our utilization ratio forecasts for Stock Connect from 80% of Southbound trading in 2015e to 30%, but our 50% utilization assumption in Northbound trading is unchanged. For 2016e, our utilization assumptions for Southbound and Northbound are 60%/100% (from 120%/100% respectively). Following the adjustment, we now forecast the SHSC to contribute 2% revenue in 2015e, and increase to 4% in 2016e.
- ▶ We have not changed our LME forecasts in 2015e and continue to forecast 280% y-o-y profit growth, led by 10% turnover growth, the trading fee hike and a full-year contribution from LME Clear. We forecast LME to contribute 24% of HKEx's revenue in both 2015e and 2016e.
- ▶ We have reduced the fee rate assumption for the derivatives business (excluding LME contracts) to reflect the change in product mix.

Overall, the increase in our ADT forecasts is offset by our lower forecasts related to SHSC and the derivatives business; consequently our profit forecasts are barely changed in 2015e and 2016e. We have also introduced our 2017e financial forecasts. We have not taken into account any impact on the expansion of the mainland connectivity into our forecasts, including potential expansion of the program to include the Shenzhen Stock Exchange, to connect with the primary market listing activities and to other asset classes.

## Revised valuation

We continue to use a three-stage residual income valuation approach to value HKEx, with an 11% medium-term revenue growth assumption and a 9% COE assumption (both unchanged). Our target price is unchanged at HKD200 and implies a 31x 2015e PE.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate for Hong Kong stocks of 8.5%. Our target price of HKD200 (including forecast dividend yield in 2015e) provides a potential return of 16%, above the Neutral band of our model; therefore, we are reiterating our Overweight rating on the stock. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

## Key risks

- ▶ **Mainland connectivity.** The SHSC was launched in 2014, which we believe is only the beginning of mainland connectivity, which is likely expand to include other exchanges and asset classes in China. However, there is no definite timetable for this and we haven't built in any further impact into our forecasts. There is also no guarantee more initiatives will be established.
- ▶ **Macro/market.** HKEx still derives over half of its revenue from market-related sources. Hence, an unexpected and prolonged market downturn would negatively affect HKEx's financial performance.
- ▶ **Policies.** We expect a meaningful percentage of medium-term growth to come from the offshore RMB business, which we expect to accelerate with China's increasing outward investment. However, the development of the offshore RMB business is top-down driven and any potential change in the policymakers' approach could affect its progress.
- ▶ **Capital flow.** HKEx is subject to international capital flows, and any significant capital movement, driven by policy changes and/or "risk-on/risk-off" globally, could lead to lower market turnover.
- ▶ **Regulations.** Exchanges are a regulated business in Hong Kong and by law HKEx is the only authorized stock exchange in the region. This has helped protect it against competition from other trading venues (including alternative trading venues). Although we do not expect HKEx's monopolistic position to change and believe the current global regulatory trend is in favour of holistic, unsegregated market operations, the situation might change and HKEx would be adversely affected if competition increases.
- ▶ **Business.** HKEx is implementing a number of key initiatives such as LME and mainland connectivity. These new projects might create new execution risks which, if not properly managed, could have an unfavourable impact.

**HKEx: Valuation (HKDm unless otherwise specified)**

	1st stage			2nd stage	3rd stage
	2015e	2016e	2017e	2nd stage (2018 to 2042)	3rd stage (terminal growth)
ROE	34%	40%	45%		
COE	9%	9%	9%		
Residual income	5,525	6,988	8,583	900,870	125,227
PV of residual income	5,525	6,411	7,224	203,540	10,288
Total value					232,989
Total shares (m)					1,165
Implied valuation					200
Implied PE (2015e)					31
Implied yield (2015e)					2.9%

Source: HSBC estimates

**HKEx: Sensitivity of valuation toward a change in revenue growth and COE assumptions in second stage (HKD/share)**

		Revenue growth (%)							
		7.0%	8.0%	9.0%	10.0%	11.0%	12.0%	13.0%	14.0%
COE (%)	7.5%	159	177	199	224	253	286	326	371
	8.0%	148	165	184	207	233	264	300	341
	8.5%	137	153	171	192	216	244	276	314
	9.0%	128	143	159	178	200	225	255	289
	9.5%	120	133	148	165	185	209	235	267
	10.0%	112	124	138	154	172	193	218	246
	10.5%	105	116	129	143	160	180	202	228
	11.0%	99	109	120	134	149	167	187	211

Source: HSBC estimates

**HKEx: Sensitivity of group revenues and profits to changes in ADT revenues for 2015e**

ADT (HKDbn)	61.9	68.7	76.4	84.9	93.4	102.7	113.0
Revenue (HKDm)	12,120	12,393	12,696	13,033	13,371	13,741	14,149
Profit (HKDm)	6,814	7,001	7,208	7,439	7,669	7,923	8,202
EPS (HKD)	5.85	6.01	6.19	6.38	6.58	6.80	7.04
Notional TP*	183	188	194	200	206	213	220

\*Notional value is derived from 31x of the EPS

Source: HSBC estimates

**HKEx: PE trading band since 2006**



Source: Bloomberg, HSBC calculations



# Disclosure appendix

## Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: York Pun and Alice Li

## Important disclosures

### Equities: Stock ratings and basis for financial analysis

HSBC believes that investors utilise various disciplines and investment horizons when making investment decisions, which depend largely on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations. Given these differences, HSBC has two principal aims in its equity research: 1) to identify long-term investment opportunities based on particular themes or ideas that may affect the future earnings or cash flows of companies on a 12 month time horizon; and 2) from time to time to identify short-term investment opportunities that are derived from fundamental, quantitative, technical or event-driven techniques on a 0-3 month time horizon and which may differ from our long-term investment rating. HSBC has assigned ratings for its long-term investment opportunities as described below.

This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at [www.hsbcnet.com/research](http://www.hsbcnet.com/research). Details of these short-term investment opportunities can be found under the Reports section of this website.

HSBC believes an investor's decision to buy or sell a stock should depend on individual circumstances such as the investor's existing holdings and other considerations. Different securities firms use a variety of ratings terms as well as different rating systems to describe their recommendations. Investors should carefully read the definitions of the ratings used in each research report. In addition, because research reports contain more complete information concerning the analysts' views, investors should carefully read the entire research report and should not infer its contents from the rating. In any case, ratings should not be used or relied on in isolation as investment advice.

## Rating definitions for long-term investment opportunities

### Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.



\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

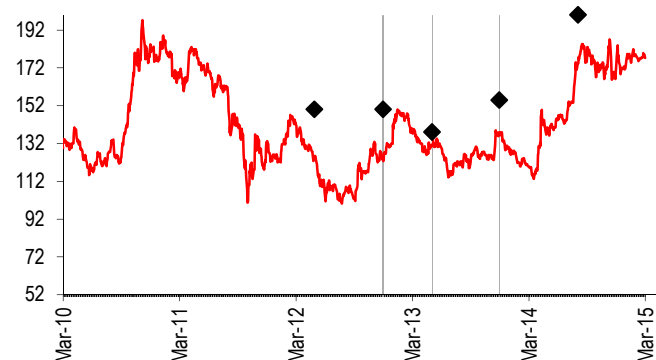
## Rating distribution for long-term investment opportunities

As of 05 March 2015, the distribution of all ratings published is as follows:

Overweight (Buy)	42%	(30% of these provided with Investment Banking Services)
Neutral (Hold)	39%	(28% of these provided with Investment Banking Services)
Underweight (Sell)	19%	(20% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities

Hong Kong Exchanges and C (0388.HK) Share Price performance HKD Vs  
HSBC rating history



Source: HSBC

### Recommendation & price target history

From	To	Date
Overweight	Restricted	29 November 2012
Restricted	Overweight	03 December 2012
Overweight	Neutral	05 May 2013
Neutral	Overweight	02 December 2013
Target Price	Value	Date
Price 1	150.00	01 May 2012
Price 2	Restricted	29 November 2012
Price 3	150.00	03 December 2012
Price 4	138.00	05 May 2013
Price 5	155.00	02 December 2013
Price 6	200.00	06 August 2014

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
HONG KONG EXCHANGES AND C	0388.HK	177.30	04-Mar-2015	4, 6, 11

Source: HSBC

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