

Hong Kong Exchanges & Clearing (0388.HK)

In-Line 2Q12; Velocity Back to 2005 Levels; How Much Worse Can it Go?

- **In-line 2Q12** — HKEx reported 2Q12 net profit of HK\$1,068mn, down 21% yoy and in line with our estimates. Revenue was 4% better than expected due to higher-than-expected clearing and depository income. However, expenses were 11% worse than expected due to HK\$92mn of cost relating to the proposed LME acquisition. Stripping out the one-off cost, pretax profit would have been 9% better than expected. We have trimmed our 2012E/13E EPS by 6-8% to reflect a lower base in 2Q12 and lower turnover, and hence trimmed our price target to HK\$123 (from HK\$133), but maintain our Buy rating as we expect good long term prospects. We expect daily stock turnover of HK\$49bn in Aug-Dec and HK\$52bn for 2012E.
- **Quiet summer...** — Amid macro uncertainties in China and globally, trading volume on HKEx has been weak this summer. Daily stock turnover fell to merely HK\$45bn in June, HK\$43bn in July and HK\$47bn in August to-date.
- **...but how much worse can it go?** — Barring a stock market collapse, there seems to be limited downside to trading volume. Turnover velocity (turnover as % market cap) has fallen to c.60% since June, i.e. back to the average in 2005. However, we believe turnover velocity on HKEx has structurally risen since 2005 due to the mega IPOs of H-shares (esp. China banks), rise of structured products (warrants + CBBCs) and increased participation of Mainland Chinese investors.
- **Macro remains key** — We believe stock turnover would improve if we were to see: (a) Signs of bottoming/recovery of macro growth in China (Chinese stocks account for about two-thirds of stock turnover on HKEx); (b) Stabilization/improvement in the European debt crisis; (c) Large-scale policy easing measures in China/US/globally.
- **LME acquisition** — We reiterate our view that the proposed LME acquisition is strategically sensible despite the expensive valuation and EPS dilution in the near term. Equities-raising is likely to finance the acquisition, but we believe this is well anticipated by the market.

Statistical Abstract

Year to 31 Dec	Net Profit (HK\$M)	Diluted EPS (HK\$)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2010A	5,037	4.67	7.1	22.9	13.3	60.3	3.9
2011A	5,093	4.72	1.1	22.7	12.6	57.1	4.0
2012E	4,245	3.93	-16.6	27.2	12.4	45.9	3.3
2013E	5,248	4.85	23.4	22.1	11.1	53.1	4.1
2014E	5,934	5.49	13.1	19.5	10.2	54.3	4.6

Source: Powered by dataCentral

- Company Update
- Target Price Change
- Estimate Change

Buy	1
Price (08 Aug 12)	HK\$107.10
Target price	HK\$123.00
	from HK\$133.00
Expected share price return	14.8%
Expected dividend yield	3.3%
Expected total return	18.2%
Market Cap	HK\$115,756M
	US\$14,927M

Price Performance

(RIC: 0388.HK, BB: 388 HK)



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Fiscal year end 31-Dec	2010	2011	2012E	2013E	2014E
Valuation Ratios					
P/E adjusted (x)	22.9	22.7	27.2	22.1	19.5
EV/EBITDA adjusted (x)	18.6	18.4	22.0	17.7	15.7
P/BV (x)	13.3	12.6	12.4	11.1	10.2
Dividend yield (%)	3.9	4.0	3.3	4.1	4.6
Per Share Data (HK\$)					
EPS adjusted	4.67	4.72	3.93	4.85	5.49
EPS reported	4.67	4.72	3.93	4.85	5.49
BVPS	8.06	8.50	8.63	9.67	10.53
DPS	4.20	4.25	3.54	4.37	4.94
Profit & Loss (HK\$M)					
Net sales	7,566	7,855	7,266	8,560	9,650
Operating expenses	-1,612	-1,823	-2,265	-2,395	-2,666
EBIT	5,954	6,032	5,001	6,165	6,983
Net interest expense	0	0	0	0	0
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	5,954	6,032	5,001	6,165	6,983
Tax	-917	-939	-756	-918	-1,050
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	5,037	5,093	4,245	5,248	5,934
Adjusted earnings	5,037	5,093	4,245	5,248	5,934
Adjusted EBITDA	5,954	6,032	5,001	6,165	6,983
Growth Rates (%)					
Sales	7.5	3.8	-7.5	17.8	12.7
EBIT adjusted	7.4	1.3	-17.1	23.3	13.3
EBITDA adjusted	7.4	1.3	-17.1	23.3	13.3
EPS adjusted	7.1	1.1	-16.6	23.4	13.1
Balance Sheet (HK\$M)					
Total assets	47,884	54,028	57,780	62,038	66,156
Cash & cash equivalent	4,788	4,667	6,436	6,436	6,436
Accounts receivable	9,221	7,228	4,979	4,979	4,979
Net fixed assets	295	948	1,448	1,448	1,448
Total liabilities	39,207	44,869	48,455	51,580	54,777
Accounts payable	13,540	11,689	10,613	11,488	12,435
Total Debt	0	0	0	0	0
Shareholders' funds	8,677	9,159	9,325	10,458	11,379
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	78.7	76.8	68.8	72.0	72.4
ROE adjusted	60.3	57.1	45.9	53.1	54.3
ROIC adjusted	97.9	89.3	91.4	118.6	108.8
Net debt to equity	-55.2	-51.0	-69.0	-61.5	-56.6
Total debt to capital	0.0	0.0	0.0	0.0	0.0

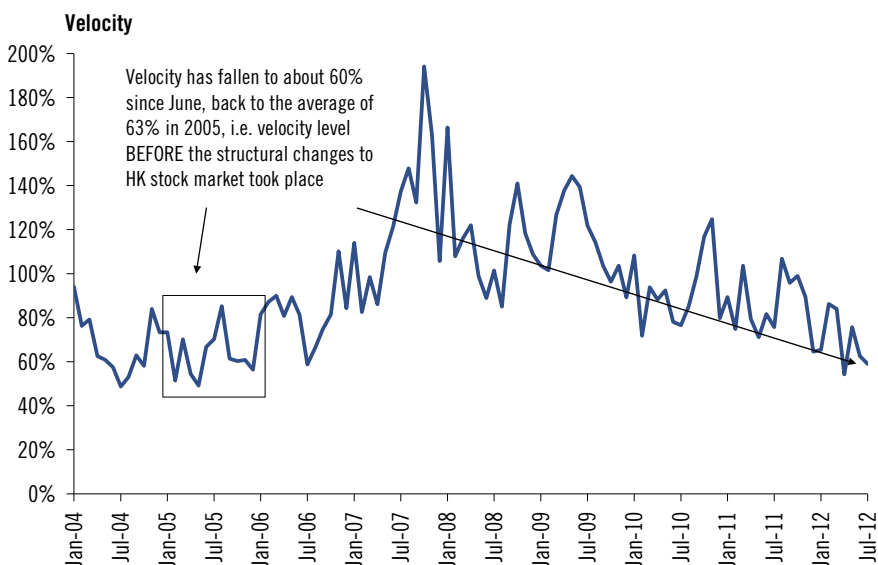
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Figure 1. In-line 2Q2012 results of HKEx (HK\$mnn)

	1Q11	2Q11	3Q11	4Q11	1Q12	Ests. 2Q12E	Actual 2Q12A	Actual vs ests.	Growth (%) Qoq	Yoy
Trading fees and trading tariffs	765	700	801	670	659	580	580	0%	-12%	-17%
Stock Exchange listing fees	246	221	247	235	244	251	218	-13%	-11%	-1%
Clearing and settlement fees	418	409	441	395	389	306	334	9%	-14%	-18%
Depository, custody and nominee services	72	322	192	99	81	239	338	42%	317%	5%
Information income	168	164	159	146	147	151	139	-8%	-5%	-15%
Core revenue	1,669	1,816	1,840	1,545	1,520	1,527	1,609	5%	6%	-11%
Investment income	111	130	(6)	155	227	152	165	8%	-27%	27%
Of which: securities gains	69	64	(88)	69	136	8	67	754%	-51%	5%
Other income	127	119	111	238	128	134	121	-10%	-5%	2%
Total income	1,907	2,065	1,945	1,938	1,875	1,814	1,895	4%	1%	-8%
Staff costs	244	274	275	237	294	309	299	-3%	2%	9%
IT related expenses	72	77	73	80	80	82	78	-5%	-3%	1%
Other operating expenses	126	123	119	123	158	160	233	45%	47%	89%
Total operating expenses	442	474	467	440	532	551	610	11%	15%	29%
Pretax profit	1,465	1,591	1,478	1,498	1,343	1,263	1,285	2%	-4%	-19%
Taxes	227	245	241	226	195	186	217	16%	11%	-11%
Net profit	1,238	1,346	1,237	1,272	1,148	1,076	1,068	-1%	-7%	-21%

Source: Company data, Citi Research

Figure 2. How much worse can it go? Velocity has already fallen to the 60% mark, similar to the average in 2005



Source: CEIC, Citi Research

Figure 3. Average daily stock turnover

	Total turnover		No. of trading days	Average daily turnover (HK\$mn)
	Mainboard (HK\$ bn)	GEM (HK\$ bn)		
Jan-11	1,567	7.0	21	74,968
Feb-11	1,303	6.9	18	72,791
Mar-11	1,813	8.7	23	79,184
Apr-11	1,426	6.6	18	79,582
May-11	1,292	8.1	20	65,007
Jun-11	1,458	5.6	21	69,684
Jul-11	1,334	3.7	20	66,884
Aug-11	1,808	4.1	23	78,783
Sep-11	1,421	2.3	20	71,147
Oct-11	1,427	2.7	20	71,474
Nov-11	1,316	3.9	22	60,007
Dec-11	926	3.3	20	46,451
Jan-12	998	2.7	18	55,618
Feb-12	1,432	4.5	21	68,411
Mar-12	1,344	4.8	21	64,238
Apr-12	901	2.6	18	50,223
May-12	1,203	2.5	22	54,809
Jun-12	950	1.6	21	45,298
Jul-12	911	1.5	21	43,455
Aug-12	236	0.3	5	47,167

Source: Datastream, Citi Research

Figure 4. Sensitivity to stock turnover and PE multiple

Daily turnover in 2013E (HK\$bn)	HKEx 2013E EPS (HK\$)	Valuation of HKEx at different P/E multiples (HK\$)										
		22	23	24	25	26	27	28	29	30	31	32
30	2.89	64	66	69	72	75	78	81	84	87	90	92
40	3.38	74	78	81	85	88	91	95	98	101	105	108
50	3.87	85	89	93	97	101	105	108	112	116	120	124
60	4.36	96	100	105	109	113	118	122	127	131	135	140
70	4.85	107	112	117	121	126	131	136	141	146	150	155
80	5.35	118	123	128	134	139	144	150	155	160	166	171
90	5.84	128	134	140	146	152	158	163	169	175	181	187

Source: Citi Research

Hong Kong Exchanges & Clearing

Company description

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Investment strategy

We rate Hong Kong Exchanges and Clearing (HKEx) shares Buy (1) with a HK\$123 target price. We see HKEx as a China macro play given c.70% of stock turnover is attributable to Chinese companies (including P-chips). Given that policy tightening and inflationary concerns in China are abating, stock turnover on HKEx will likely rise. Longer term, we believe HKEx should benefit from capital inflows as China liberalizes its capital account, although there will also likely be more competition as Shanghai rises as an international financial centre.

Valuation

Our target price of HK\$123 is based on 29x mid-2013E EPS (previously based on 31x 2012E EPS), with the fair-value multiple derived from a 3-stage DDM model given the stable dividend payout ratio of HKEx. Key assumptions are 11.0% discount rate, 15% first-stage growth, 12.5% second-stage growth, and 4% terminal growth.

Risks

Downside risks that could impede the stock from reaching our target price include continued weak/falling turnover, draconian tightening measures in China, and further decline of HK/China stock markets.

Appendix A-1

Analyst Certification

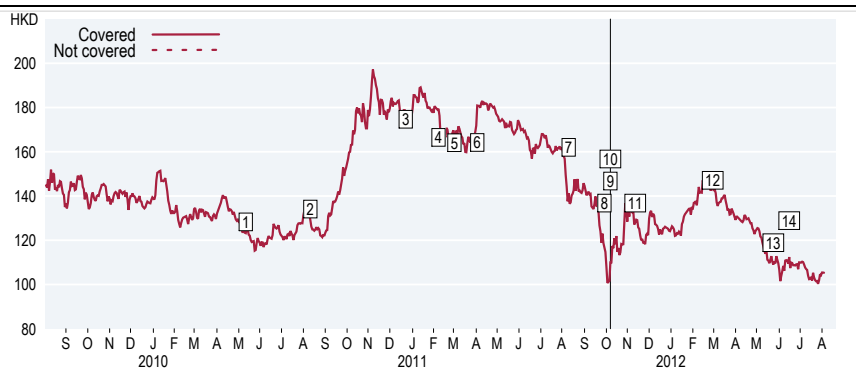
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Analyst: Darwin Lam, CFA
Covered since May 12 2010



Date	Rating	Target Price	Closing Price
1 12-May-10	*3L	*116.00	123.20
2 11-Aug-10	3L	*123.00	129.10
3 23-Dec-10	3L	*135.00	176.00
4 8-Feb-11	3L	*148.00	179.40
5 2-Mar-11	3L	*160.00	167.10

* Indicates change

Date	Rating	Target Price	Closing Price
6 3-Apr-11	*1L	*206.00	171.80
7 10-Aug-11	1L	*176.00	141.20
8 29-Sep-11	1L	*160.00	118.70
9 7-Oct-11	Stock rating system changed		
10 7-Oct-11	*1	160.00	110.00

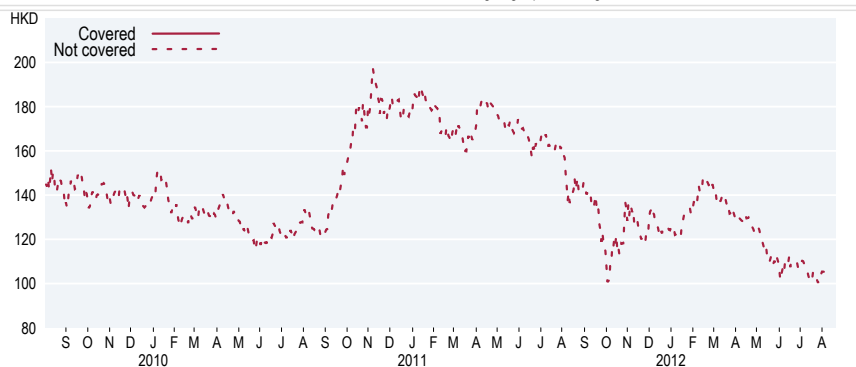
Date	Rating	Target Price	Closing Price
11 11-Nov-11	1	*150.00	128.00
12 29-Feb-12	1	*163.00	144.60
13 24-May-12	1	*148.00	109.00
14 15-Jun-12	1	*133.00	112.40

Rating/target price changes above reflect Eastern Standard Time

Hong Kong Exchanges & Clearing (0388.HK)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Darwin Lam, CFA
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Data current as of 30 Jun 2012

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% of companies in each rating category that are investment banking clients

12 Month Rating			Relative Rating		
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53%	37%	10%	10%	80%	10%
44%	43%	40%	48%	43%	45%

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