ASIA STOCK PANS

This Bear Says Sell Hong Kong Exchange's Shares

By Daniel Shane November 25, 2015

Photographer: Jerome Favre/Bloomberg

Hong Kong's stock exchange can thank a fat finger for the leg up in its share price in early November. An accidently-published – and incorrect – report by China's central bank that a stock-trading link with neighboring Shenzhen will go live this year sparked an intra-day 9% spike in shares of Hong Kong Exchanges and Clearing.

The bungle not only showed how keen investors are to trade the frothy Shenzhen market but, more importantly, how closely linked the shares of Hong Kong Exchanges and Clearing (388.HK) are to policy cues from China. *Barron's Asia* wrote positively about the stock in October 2014 - shares have gained 20% since - and we still like the stock as a long-term play on the development of China's capital markets. However, one bearish analyst argues investors looking to commit fresh funds to the stock may be better off waiting for entry given the stock's rich valuations and lack of short term catalysts.

Haitong's Tony Tanaka reckons the market is over-egging the importance of the proposed Shenzhen stock link, which he believes will be delayed until the end of next year. He cites trading volumes on the Shanghai-Hong Kong Stock Connect, which have disappointed since launching a year ago. He doesn't expect trading in Shanghai stocks from Hong Kong to pick up until more A-shares are added to global benchmarks. Earlier

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While he likes Stock Connect because it boosts liquidity in China's stock markets, Tanaka says the exuberance isn't justified. HKEx currently trades at almost 40 times trailing earnings, slightly above its five-year average. If the HKEx is to meet market expectations, he calculates the stock exchange operator will have to double the average volume of daily trading from its current HKD90 billion to HKD180 billion within the next few years. Tanaka doesn't think that's going to happen. Surprisingly, given its size and global prominence, Hong Kong's annual share turnover is less than half that of either Shanghai or Shenzhen. Compared to New York or London, it's positively microscopic.

But Tanaka isn't the only analyst giving HKEx a kicking. Deutsche Bank downgraded the stock from buy to hold after the bourse's third quarter earnings fell 25% after gains from the sale of property were stripped out. Analyst Sukrit Khatri says China's clumsy attempts to support the Shanghai market earlier this year (everything from banning IPOs to jailing recalcitrant journalists) will keep some investors out of Hong Kong well into 2016. Conscious of past mistakes, Chinese policymakers will take their time making sure they get the Shenzhen-Hong Kong Stock Connect right. "Connectivity projects are likely to bear fruit later than expected, likely hampering HKEx's short-term allure and earnings capability," Khatri says. He thinks there's more money for Hong Kong in promoting more China-focused ETFs and derivative products. The stock is "lacking near-term turnaround catalysts," he laments.

Haitong's Tanaka, who thinks HKEx's stock will fall 15% to HKD180 a share, says the long-term case for Hong Kong as a conduit for China's behemoth financial markets is largely intact. However, he warns that Hong Kong's exchange may become less relevant as China's financial markets mature. "Hong Kong's role may become less unique" as China presses ahead with liberalizing its financial system and capital account, he says. As this goes on more Chinese firms will consider capital-raising in Shanghai or Shenzhen instead of Hong Kong. HKEx needs to find new ways of innovating or could become "'just another exchange' in China," he notes.

Those who feel the need to have a stock exchange in their portfolio could consider Singapore Exchange (S86.SG). The Lion City's bourse is trading near a five-year low of 22 times last 12 months earnings, a reflection of the 4% decline in its share price so far this year. Brokers or asset managers are probably a better bet and play on similar themes. CITIC Securities (6030.HK) is up 25% and trades at an inexpensive eight times trailing earnings. *Barron's Asia's* Isabella Zhong wrote positively about fund management group Value Partners (806.HK) in May. The Hong Kong asset manager is exposed to demand for Chinese stocks through its fund products. Its share price has enjoyed a good three months and could go about 30% higher in the next year.

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Stock Disconnect

Hong Kong Exchanges & Clearing Ltd.

Source: Dow Jones Market Data

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