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Why Hong Kong Exchange Stock Can Fall 20%

By Daniel Shane June 1, 2016

The flag of the Hong Kong Exchanges and Clearing Ltd. (HKEx), flies in the Central district of Hong Kong, China. Photographer: Xaume Olleros/Bloomberg

In a lousy year for Hong Kong shares, the one stock you didn't want to own is the stock market operator itself.

Hong Kong Exchanges and Clearing (ticker: 388.HK), which runs the Asian hub's bourse, has slumped nearly 40% over the past year. Trading volumes have been hammered amid a rout in Chinese equities, while a stock link with Shanghai has failed to get local traders' pulses racing. Investors should buckle up for another 20% plunge in the shares.

That bearishness was certainly evident in both the top and bottom line of the exchange's latest quarterly results. In the first quarter revenues fell 2% year-on-year and EBITDA 9%, both below the market's generally lowly expectations. Cash equity trading, the Hong Kong bourse's bread and butter, was especially bleak as it fell 10% compared to a year ago. Derivatives trading and IPO fees, both smaller chunks of revenue, were bright spots as they chipped in more top line.

Investors hoping for a reprieve from the earnings squeeze from the planned trading link between stock markets in Hong Kong and its neighbor immediately to the north, Shenzhen, shouldn't get too excited. The platform will allow traders to freely buy-and-sell stocks in Shenzhen, where a lot of mainland Chinese small caps are listed. At the squib. As my colleague William Pesek puts it, the Shanghai connect "arrived just in time to share the mainland's USD5 trillion rout." A year-and-a-half after launching it contributes just 1% of the exchange's revenue. When the Shenzhen link will go live is anyone's guess. On a recent trip to Hong Kong, China's number three official Zhang Dejiang left investors hanging by keeping mum on the topic.

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One long-term bear on the stock is Haitong analyst Tony Tanaka, who rates the shares as a Sell. In a grizzly analysis Tanaka says while "stock connects are highly favorable to HKEx's equity story, we doubt that they can contribute much to its revenue." Investors in China could also be less likely to trade Hong Kong-listed shares if the yuan keeps weakening or if authorities tighten up capital controls. Both give investors fewer reasons to buy Hong Kong stocks, which are quoted in the U.S. dollar-linked Hong Kong currency.

A bigger problem in Tanaka's view is that once the Shenzhen connect launches there's nothing left on the horizon for investors to get pumped about. This means they will shift focus back to the Hong Kong exchange's other fundamentals, like its trading volumes, which have been looking anemic for a while. The bourse offers trading in an array of asset classes including derivatives and commodities through the London Metal Exchange, but it still rakes in a big chunk of its revenue through old fashioned buying and selling of stocks. Average monthly trading has plunged by up to two-thirds since last summer's highs and Tanaka reckons they'll slide further as recent volatility in markets gradually recedes. Perhaps surprisingly given Hong Kong's status as one of the world's top financial centers, trading volumes weren't all that hot to start with, relatively speaking. On an average day in April this year, roughly $7 billion worth of shares changed hands in Hong Kong. That looks puny compared to, say, the Nasdaq, where on any given day in the same month between $60 billion and $90 billion of stocks were bought and sold.

Hong Kong exchange's decision to acquire the London Metal Exchange four years ago has yet to deliver. The bourse's bosses were widely touted as having paid over the odds for the global commodities exchange, and its costs look like they're adding up. Trading volumes in metals contracts have fallen amid the commodities rout and after the LME jacked up its fees. Wan Li, an analyst at BOCOM International, says cost pressures at LME could also drag on the group's earnings overall. The metals exchange has recently seen its costs rise by about a quarter as it spent more on technology upgrades and clearing services.

Haitong's Tanaka's been right on this stock before. When Hong Kong exchange's shares were trading at HKD210 in November last year, he said they were worth HKD185. The stock plunged to HKD160 within a couple of months. Tanaka's got his crystal ball out again and says they could sink another 18% from its recent price to

HKD300. We turned bearish on the shares a year later when it emerged the much-hyped Shanghai connect hadn't met expectations.

Based on its recent price the bourse trades at about 33 times forward earnings, slightly above its five-year average. That makes "it by far the most expensive exchange in the world," Tanaka points out. A cheaper alternative could be Singapore Exchange (S68.SG), which trades at about a one-third discount to its Hong Kong peer. As *Barron's Asia* writer Isabella Zhong wrote a few months back, the Lion City's exchange has carved out a niche as a derivatives trading hub built on Singapore's reputation in commodities and currency trading. The stock has a chunky return on equity of more than 40% - much higher than the Hong Kong bourse's - and pays a 4% dividend. The shares are up about 15% since a January low, too.

Bearing the Brunt

Hong Kong Exchanges & Clearing Ltd.

Source: Dow Jones Market Data

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