

**Analyst: Paul Sham**

## **HONG KONG EXCHANGES AND CLEARING LIMITED** (香港交易所)

Sector	: Financial Services	Chairman	: Mr. Ronald Joseph Arculli
HKSE Code	: 0388	Chief Executive	: Mr. Paul Chow Man Yiu
Market Price	: HK\$103.50 (13/08/2008)		
Shares Issued	: 1,070.9m		
Mkt. Cap.	: HK\$110,838.2m		
52 weeks Hi/ Lo	: HK\$268.60 / HK\$96.80		
HSI	: 21,304.52 (13/08/2008)		
Main Business	: Stock & futures exchange operations		

### **SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30<sup>TH</sup> JUNE 2008**

#### **Interim Results Highlights**

	<b>1H2008</b>	<b>1H2007</b>	<b>y-o-y</b>
	<b>HK\$ million</b>	<b>HK\$ million</b>	<b>Change</b>
• Turnover	4,211.3	3,156.9	+33.4%
• Operating expenses	(768.9)	(665.6)	+15.5%
• Operating profit	3,442.4	2,491.3	+38.2%
• Gain on disposal of an associate	0.0	206.3	-100.0%
• <b>Profit attributable to shareholders</b>	<b>2,974.4</b>	<b>2,330.3</b>	<b>+27.6%</b>
	<b>HK\$</b>	<b>HK\$</b>	
• Basic EPS	2.78	2.19	+26.9%
• Interim DPS	2.49	1.79	+39.1%

#### **Key Market Statistics**

• Average daily turnover value on the Stock Exchange (HK\$ billion)	87.3	59.2	+47.5%
• Average daily number of derivatives contracts traded on the Futures Exchange	191,179	145,852	+31.1%
• Average daily number of stock options contracts traded on the Stock Exchange	238,970	131,040	+82.4%

- Hong Kong Exchanges and Clearing ("HKEx") reported a 27.6% y-o-y increase in net profit to HK\$2,974.4m in 1H08. If compared q-o-q figures, HKEx's net earnings for 2Q08 dropped 20% to HK\$1.32bn, from HK\$1.65bn in 1Q08, showing the earning momentum of HKEx was decelerating.
- Contrasting the 33.4% y-o-y top-line growth, the relatively slower bottom-line increase was due to the absence of a one-off gain of HK\$206m in 1H07 from the disposal of a 30% interest in share registration company - Computershare Hong Kong.
- Turnover jumped by 33.4% y-o-y to HK\$4,211.3m in 1H08. The main drivers were a 47.5% y-o-y increase in average daily turnover (from HK\$59.2bn in 1H07 to HK\$87.3bn in 1H08) and a 55.3% increase in the number of derivative and option contracts traded.
- Basic EPS was HK\$2.78. A dividend of HK\$2.49 was declared, representing a payout ratio of 89.6%, compared to 81.7% in 1H07.

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**Business Review**

- Turnover breakdown:

	1H2008		1H2007		Change
	HK\$ million		HK\$ million		
Trading fees/trading tariff	1,553	36.9%	1,075	34.0%	+44.5%
Clearing/settlement fees	775	18.4%	571	18.1%	+35.6%
Depository/custody/nominee services fees	296	7.0%	308	9.8%	-4.0%
Stock Exchange listing fees	356	8.5%	294	9.3%	+21.1%
Income from sale of information	354	8.4%	276	8.7%	+28.6%
Net investment income	590	14.0%	453	14.3%	+30.3%
Gain on disposal of properties	69	1.6%	0	0.0%	NA
Other income	218	5.2%	180	5.7%	+21.1%
<b>Total turnover</b>	<b>4,211</b>	100.0%	<b>3,157</b>	100.0%	+33.4%

- **Trading fees and trading tariff** jumped 44.5% in 1H08 on higher market turnover of both the Cash and Derivatives Markets. The average daily turnover on the Exchange shot up by 47.5% y-o-y to HK\$87.3bn in 1H08, while the average daily number of derivatives and options contracts traded in 1H08 also increased 55.3% y-o-y. However, considering q-o-q comparison, average daily securities turnover dropped from HK\$98.7bn from 1Q08 to only HK\$76.1bn for 2Q08, representing a 23% q-o-q decline. Trading activities in the Derivatives Market were also cooled down, with average daily number of derivatives contracts traded dropped 14% q-o-q and average daily number of stock-option contracts traded also decreased 20% q-o-q. On the other hand, **clearing and settlement fees** grew 35.6% y-o-y, mainly attributable to the strong Cash Market transactions. **Depository, custody and nominee fees** decreased slightly by 4.0% y-o-y in 1H08, mainly due to a decrease in electronic-IPO handling fees as the number of newly listed companies fell.
- HKEx's income from **Stock Exchange listing fees** rose 21.1% y-o-y in 1H08, with both annual listing fees and initial & subsequent issue listing fees recording healthy y-o-y growth of 15% and 27%, respectively. The increase in annual listing fees was attributable to the higher number of listed securities, increasing to 1,254 as at 30/6/2008, from 1,196 a year earlier. Regarding the initial and subsequent issue listing fees, the bright spot was on the number of newly listed Callable Bull/Bear Contracts (CBBCs), which increased from 74 in 1H07, to 953 in 1H08, representing a 1,188% y-o-y growth. The number of newly listed companies on Main Board dropped from 32 in 1H07 to only 21 in 1H08, raising an aggregate HK\$117bn during 1H08 (1H07: HK\$187.6bn). On the other hand, fund raised via GEM amounted to HK\$5.2bn (1H07: HK\$7.9bn), with 2 new listings during 1H08 (1H07: 0). Meanwhile, the number of newly-listed derivative warrants totalled 2,777 in 1H08, up more than 20% from 2,305 a year earlier.
- **Net investment income** grew 30.3% y-o-y in 1H08, primarily due to the significant increase in net interest income as a result of the larger average investment fund size (HK\$69.9bn, +97% y-o-y) but partly offset by the drop in interest rates and significant decrease in fair value gains of Corporate Fund investments, reflecting market movements. For 1H08, the annualised net return on HKEx's investment funds was 1.69%, down from 2.55% a year earlier.
- HKEx's operating expenses rose by 15.5% y-o-y in 1H08. Staff costs, comprising 58.8% of total operating expenses, increased by 17% y-o-y, primarily due to increase in headcount and salary adjustment in 2008 as well as an increase in performance bonus accruals. With a 33.4% y-o-y increase in total income, HKEx's cost-to-income ratio lowered to 18.3% for 1H08 from 21.1% a year earlier.

**Outlook & Prospect**

- **Market activities as the ultimate earning driver** Trading fees and settlement fees are the two main income sources for HKEx, representing 36.9% and 18.4% of total turnover in 1H08. Although other stable revenue (e.g. listing fees, information revenue, depository/corporate action fees) is more resilient than transaction-based revenue, we believe it is ultimately still a function of market activities. If there were a prolonged slump in stock market and turnover, it would inevitably exert pressure on stable revenue. With the PRC A-share market still uncertain now, the launch of the “HK Stock Direct Train” program and further QDII quota approvals might not be able to boost the Hong Kong market turnover like before. However, we believe that current market velocity of HK\$60bn to HK\$70bn Average Daily Turnover is quite sustainable, as Hong Kong market is still the only real “point of entry” for overseas investors to participate in China’s economic growth.
- **The rise of Callable Bull/Bear Contracts (CBBCs) compensated the decline of warrants** HKEx has achieved great success in listed structured products, being the largest exchange in the world in term of derivative warrants turnover. The daily turnover of Hong Kong’s warrant market reached HK\$21.2bn in 1H08 but is expected to drop in the next 6 months due to continued market corrections. Despite this, CBBCs, first launched in mid-2006, accounted for 0.4% and 2.5% of total stock market turnover in 2H07 and 1H08, respectively. We think CBBCs could be another popular product after warrants, which will receive growing demand from investors. The strong growth of CBBC turnover should be able to offset the decline in warrants trading.
- **Innovative approach on the way** HKEx’s improving innovation remains the key to sustain its growth amid the recent turbulent market. During the result presentation, management reported that they are planning to launch a carbon emission futures contract by the middle of 2009. Together with the previous development of CBBCs, HK Depository Receipts and gold futures, HKEx is pursuing active approach on adding new products to the Hong Kong market. Although the overall trading of these products is not expected to have a significant impact on HKEx’s immediate earnings, we believe it is the right direction to transform HKEx into one of the world’s major exchanges, along the lines of Tokyo, London and New York.
- **Buying opportunity begins to arise** The stock is currently trading at 18.4x FY08 earnings, with a dividend yield of 5%. The weakened Average Daily Turnover in 2008 is likely to weigh down on sentiment over the share price in the near term. However, in terms of the ‘market share’ of stock turnover in global stock exchanges, we think HKEx’s current level, which is around 2% in 1H08, is still moderate if the Hong Kong market can be transformed into the leading regional financial centre, surpassing Tokyo. We think that the current negative sentiment creates an opportunity for long-term investors. We accordingly recommend a “Buy on weakness” rating for the counter.

**Recommendation: Buy on weakness**



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