



Caldwell Investment Management Ltd.

Independent Investment Managers

EXCHANGE SECTOR UPDATE

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The year 2011 was on track to be the most active in the exchange sector in many years. However, regulators and politicians had other plans. It all began in April, with the Australian regulator rejecting the proposed takeover of the Australian Exchange (“ASX”) by the Singapore Exchange Ltd. (“SGX”).

Then, the IntercontinentalExchange Inc. (“ICE”) and the NASDAQ OMX Group Inc. (“NASDAQ”) were forced to drop their financially stronger counter offer for the NYSE Euronext (“NYX”) because it could not get approval from the US Department of Justice. This paved the way for the NYX and the Deutsche Boerse (“DB1”) to move forward with their friendly consolidation. Yet early this month, EU antitrust examiners recommended prohibiting the deal from progressing, stating concerns about the potential creation of a European monopoly in exchange-traded futures and options.

In June, a similar scenario unfolded in Canada. The TMX Group Inc. (“TMX”) agreed with LSE to terminate their friendly merger agreement after significant pressure from the hostile and patriotic Maple Group (“Maple”) offer. Now, the Maple offer is being scrutinised by the Canadian Commissioner of Competition and many reports suggest it may not be approved.

Notwithstanding these deals that have been blocked by governments and some nationalist interests, some smaller deals have been approved in record time, suggesting that the opportunities in the exchange sector may currently lie in these secondary assets. For example, on December 30th, three months after announcing its intention to acquire the all-electronic National Stock Exchange (“NSX”), the CBOE Stock Exchange (“CBSX”) secured Securities and Exchange Commission (“SEC”) approval. This 90 day approval time frame compares to well above a year for the majority of the larger deals in the exchange sector.

New York Stock Exchange

- NYSE Euronext (“NYX”) remains the principal venue for companies raising capital. With \$33 billion in total global proceeds from 104 IPOs in 2011, NYX raised more proceeds from Initial Public Offerings (“IPOs”) than any other global exchange group. In the U.S., for the fifth consecutive year, NYX led the market for IPOs and total proceeds raised with 89 IPOs.
- For the third quarter of 2011 (“Q3/11”), the earnings per share (“EPS”) of the NYX were up 56% to \$0.76, and beat analysts’ expectations by 12%. Net Revenue increased 18% to \$704 million, the highest level of net revenue generation since the third quarter of 2008.



Toronto Stock Exchange

- For Q3/11, the TMX Group Inc. (“TMX”) reported revenue of \$167.8 million, up 15% from Q3/10 and diluted earnings per share of 90 cents, up 22% from Q3/10 and exceeding the analysts’ expectations by 5 cents. Excluding the 2 cents per share impact of the London Stock Exchange plc (“LSE”) and Maple Group (“Maple”) related costs, the adjusted diluted EPS in Q2/11 was 92 cents compared with diluted EPS in Q2/10 of 74 cents, a 24% increase quarter over quarter.
- On December 21, 2011, TMX purchased a 16% minority stake in the Bermuda Stock Exchange (“BSX”) and became one of the largest shareholders of the BSX. Earlier in the year, a Tax Information Exchange Agreement, which gave the BSX recognition as a Designated Stock Exchange under Canada’s Income Tax Act, was signed between Canada and Bermuda. We believe that there is potential for the TMX to list and launch products for the U.S. and international markets from the BSX offshore platform.

Chicago Board Options Exchange Inc.

- For Q3 2011, the EPS of the Chicago Board Options Exchange (“CBOE”) was up by 125% to \$0.45, matching expectations. Operating margins improved for the fifth consecutive quarter to 52%, the highest reported in the company history. The average transaction fee per contract increased 2% to \$0.31, illustrating the benefits of CBOE’s proprietary products.
- CBOE volumes increased 8% to 1.2 billion in 2011, exceeding 1 billion contracts for the 4th consecutive year. The CBOE Futures Exchange (“CFE”) and C2, the new electronic CBOE exchange are two recent CBOE ventures with a lot of potential that may add new revenue streams for the CBOE.
- The year 2011 was the busiest in the CFE history, as trading volume increased 174% to top 12 million contracts for the first time ever. The CFE remains to be watched closely as its products are the most expensive to trade, yet they are getting a lot of traction. The CBOE generates five times more revenues per future contracts than it does per option contracts, \$1.37 vs. \$0.30.
- In 2011, C2’s first full year of operation, trading volume totaled 53 million contracts, an average daily volume (“ADV”) of 209,600 contracts. Index option volume averaged 5,100 contracts per day since SPXpm, the new S&P 500 index option product was launched on October 4. C2 volume during December totaled nearly 3.9 million contracts, an ADV of 184,900 contracts, up 67 percent from December 2010 and down 20 percent from November 2011. At the end of 2011, C2’s market share of total U.S. options volume was 1.2 percent.
- The CBOE remains very active on the innovative and entrepreneurial front. In December, it announced an investment, through an affiliate, in the Intellectual Property Exchange International (“IPXI”), the first financial exchange focused on intellectual property. IPXI has set out to build out its infrastructure and to facilitate the issuance of Unit License Right™ (“ULR”) contracts in 2012. ULR contracts will be designed to allow intellectual property owners to monetize their patents using standardized contracts and transparent pricing, versus traditional bilateral licensing of patents.



Kansas City Board of Trade (“KCBOT”) and Minneapolis Grain Exchange (“MGEX”)

- In 2011, a total of 6,582,673 contracts were traded at the KCBOT, setting a new record with a 15.5 percent increase over the 5,697,874 contracts traded in 2010. These increasing volumes, combined with the continuous shift from floor trading to the more profitable electronic trading should help not only boost the earnings of the KCBOT, but also sustain or increase the current dividend yield of 7.2%.
- During the calendar year (“CY”) 2011, the MGEX volumes increased 3% to 1.8 million contracts, the second highest CY volume in the 130 year MGEX history. For the fiscal year (“FY”) which ends in August, the MGEX set a new record by trading over 2 million contracts. It exceeded its previous FY 2008 record by 20%, or over 328,000 contracts. These record volumes translated into strong FY 2011 earnings. Revenues and net income increased 7% and 30% to \$9.8 and 1.4 million respectively. Operating margins increased to 23% from 18% as good costs controls kept expenses steady.
- The coming years present many opportunities for the MGEX. First, the upcoming demise of the Canadian Wheat Board should bode very well for the exchange if it plays its cards right. Second, the MGEX recent reorganisation opens the door for a potential tie-up with the right partner, or dividend payments to the seat owners. The initiation of a dividend payment should help improve the valuation of the MGEX, which is already taking many steps to improve its competitiveness and profitability. For instance, the MGEX recently welcomed some very well connected, experienced and profit driven seat owners and traders on its board.

Bombay Stock Exchange (“BSE”)

- For the half year ended September 2011, the BSE had revenues and net income of \$54 million and \$21 million, increasing 10% and 2% respectively. The operating margins remained steady at 59%. At our current valuation of 300 rupees per share, this run rate implies a valuation of 14x earnings for the BSE.
- SEBI, the Indian securities regulator, has still not made a formal announcement regarding the recommendations of the Jalan committee. Yet, two recent developments lead us to think that the majority of the Jalan recommendations will not be implemented, which would be a positive for the Indian exchanges. First, Mr. U.K. Sinha, who is considered more liberal than his predecessor and less likely to implement damaging recommendations, was appointed as chairman of SEBI in February. Second, last September SEBI allowed the Multi Commodity Exchange (“MCX”) to proceed with its IPO, thereby sending a very positive message to Indian stock exchanges.
- The Liquidity Enhancement Incentive Programs (LEIPS) initiated by the BSE last September in its derivatives segment is paying off. For example, on November 17th, the BSE set a new daily turnover record high of \$311 million and beat by 6% its previous February 2008 record. Also, the BSE Sensex futures have now improved their daily market share of Indian index futures to approximately 7%. With a few months left in the LEIPS, the BSE will soon have to make the difficult decision of wrapping it up or extending it.



- Last quarter, the BSE received approval from SEBI to launch a new exchange for small and medium enterprises (“SME”). Modelled after SME Exchanges like AIM (London), Canada (TSXV), Hong Kong (GEM), Japan (Mothers), Korea (KOSDAQ) and US (NASDAQ), the BSE SME should ease Indian SMEs access to both debt and equity capital. This should also translate into an additional revenue stream and improved earnings for the BSE.

Budapest Stock Exchange (“Budapest”)

- Budapest is one of the few remaining stand alone fully integrated European exchanges, after the massive international consolidation of Nasdaq OMX in the Northern part of the continent, NYSE Euronext in the central part and the London Stock exchange (“LSE”) tie-up with Borsa Italiana. In the Eastern part of Europe the biggest consolidator has been Wiener Borse.
- For the first half of 2011, Budapest revenues and net income decreased 16% and 39% to \$6.4 and 2.1 million respectively. During the period, operating margins decreased from 57% to 40%, mainly because of a sudden 15% increase in operating costs. Volumes also decreased 42% over the previous year. We expect the second half of the year to be better because the volumes decreasing trend decelerated to 15%.
- At our current valuation of €15/share, Budapest’s dividend yield is 6.85%.

CURRENT OPPORTUNITIES WITHIN THE EXCHANGE SECTOR

The unintended consequences of regulations such as Mifid and REG NMS have forced incumbent exchanges to remain competitive by seeking economies of scale through mergers and acquisitions. While this strategy worked very well in the first part of last decade, regulators and strong patriotic interests have recently blocked a few large consolidations but cleared the way for smaller transactions in record times.

We still believe the exchange sector will strongly benefit from the efforts of the central banks around the world to stimulate the global economy by increasing the money supply. The additional money created will eventually find its way onto cash and derivatives markets, increasing the pool of capital available for trading. Also, the increasing regulation of over-the-counter products (“OTC”), which many blame for the 2008 financial crisis, will significantly benefit the derivatives exchanges and their clearing operations. A growing number of OTC products will be required to be customised and cleared through exchanges in order to reduce the counterparty risk.

In the short to medium term, the biggest opportunities in the exchange industry may lie within the secondary exchanges like the U.S. grain exchanges, the European smaller markets, and India’s BSE, where regulatory approval and patriotic interests will probably not be a huge concern if/when a deal was proposed.

Armel Kitieu, CFA

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