Urbana Corp.

Summary

* Accounts managed by Kerrisdale currently own shares of Urbana Corp. (URB on the Toronto Stock Exchange), a closed-end fund with holdings in securities exchanges and financial services companies.
* Urbana is trading at a 30% discount to its Net Asset Value of $2.06. The fund owns three main assets: (1) shares of CBOE, which account for 27% of the portfolio, (2) shares of NYSE Euronext, which account for 40% of the portfolio and (3) shares in the privately held Bombay Stock Exchange, which account for 15% of the portfolio. The rest of the fund's holdings are comprised of a variety of smaller public and privately held securities exchanges, as well as several public and private financial services companies.
* Owning the company's portfolio at a 30% discount strikes us as a reasonably attractive proposition. The fund's investment manager, Tom Caldwell, is an experienced veteran in the exchange space as well as the broader financial services industry. We hope that he continues to repurchase shares, which seems to be the best use of capital given the stock's current discount to NAV.

Accounts managed by Kerrisdale currently hold Urbana stock, and we may buy or sell shares at any time. We will not disclose our sale if and when we sell, and we will not necessarily disclose that we have changed our thesis if we discover something faulty with our analysis at a later date.

Introduction

Urbana is a publicly traded closed-end fund. The fund owns financial services assets, primarily in the securities exchange sector, and is managed by Caldwell Financial Ltd, an investment manager that has been run by Tom Caldwell since the 1980s. Caldwell has been a prominent investor in private exchange seats and an advocate of demutualization, public offerings and industry consolidation in the exchange universe.

Historically, Urbana tended to act as a vehicle that allowed public investors to invest in private exchange seats. Several years ago, much of the company's holdings were in the seats or private ownership stakes of exchanges like the NYSE, AMEX, CBOE and numerous other domestic and international stock exchanges. Over time, many of those exchanges have gone public and today, 70% of the portfolio is comprised of publicly traded stock. The two largest positions are shares of CBOE and NYSE Euronext, both of which Urbana had acquired through owning pre-IPO stakes.

Urbana provides helpful one-pagers on a regular basis that calculate the fund's NAV. The most recent is attached here. I've also pasted it below:

The NAV of the portfolio is $2.06. The stock currently trades at $1.45 - a 30% discount to the NAV. As we can see, the fund's three big holdings are shares of CBOE and NYSE Euronext and a private stake in the Bombay Stock Exchange, India's second-largest stock exchange. Together, these comprise 80% of the portfolio. At the end of this post, we'll briefly discuss each of these three holdings.

<u>Share Structure and Caldwell Ownership</u>

Urbana has 80 million shares outstanding, of which 10 million are voting "Common Shares" and 70 million are non-voting "Class A" shares. As of the 2010 proxy, the Caldwell family owns 6.5m common shares, and with an additional 0.4m of Class A shares, they collectively own approximately 10% of the company.

Urbana also has 5.3 million outstanding warrants to purchase A Shares at an exercise price of $2.50 per share, expiring November 10, 2011. Given that the exercise price is more than 70% above the current trading price of $1.45, these warrants are not a concern to us.

<u>Deployment of Capital</u>

Before discussing the fund's primary holdings, we'll address the risk that Caldwell makes poor future investment decisions that squander value and reduce the fund's NAV to the current stock trading level.

While poor future capital deployment is a risk, it does not appear to be an especially material one. Caldwell's experience in this industry is lengthy and his track record within the financial services industry is relatively strong. We'll note that many of his fund's holdings are currently priced at below the fund's cost to acquire them, and NAV at Urbana hasn't been increasing over the past few years.

NAV for the years ending December 31st:
2005: $1.26
2006: $2.69
2007: $3.37
2008: $2.06
2009: $2.00
Present: $2.06

However, much of the decline was due to the market downturn and the general decline in exchange valuations during the recession. Caldwell's investments in small international exchanges have also performed poorly.

From speaking to Caldwell, however, it appears that the manager is shifting away from investments in smaller exchanges and is currently focusing on repurchasing shares. On February 9, 2011, the company announced that it has reduced its share count by more than 10% in the past 10 months. Given the current discount to NAV, that's exactly what we'd like to see.

Of course, there certainly remains a risk that Caldwell makes a poor future investment choice. But given the 30% discount to NAV, we are willing to take that risk.

Holdings

We'll provide a discussion of Urbana's top three holdings, which collectively comprise 80% of the fund. The remaining holdings are relatively small and diversified, so we don't view them as particularly material. From speaking with Caldwell, we didn't sense that he's eager to increase any of these smaller holdings when compared to the relatively higher attractiveness of repurchasing Urbana shares.

NYSE Euronext (40% of the fund)

NYSE Euronext operates a variety of leading securities exchanges. These include:

* NYSE: the leading and most liquid cash equities exchange in the world.
* Euronext: an integrated cross-border exchange which combines the stock exchanges of Amsterdam, Brussels, Lisbon and Paris into a single market. As of December 31, 2009, Euronext was Europe's second-largest stock exchange group based on aggregate market capitalization of listed operating companies.
* NYSE Liffe: NYSE Liffe is the international derivatives business of NYSE Euronext. In 2009, NYSE Liffe was the second-largest derivatives market in Europe by volume, and the second-largest in the world by average daily value of trading.
* NYSE Arca: NYSE Arca is a fully electronic exchange in the United States for equities and exchange traded products, including exchange traded funds ("ETFs") and exchange traded notes ("ETNs").
* In addition, the company operates NYSE Arca Europe, NYSE Alternext, NYSE Amex, NYSE Liffe US, and several additional businesses.

Several weeks ago, NYSE Euronext announced that it would merge with Deutsche Boerse, with NYSE shareholders owning 40% of the combined company and Deutsche Boerse holders owning the remaining 60%. The merged company will be the largest exchange in the world by both revenue and EBITDA. It will have a geographically diverse footprint and business mix - 67% of 2010 combined revenue is from Europe, Middle East and Africa, 31% from the Americas, and 2% from Asia. In terms of product diversity, the company will generate 35% of revenue from derivatives, 30% from cash trading and listings, 20% from settlement, and 15% from market data / technology.

We owned shares of Deutsche Boerse prior to the merger, and NYSE Euronext's valuation multiples are not particularly lofty, at approximately 14x 2011 P/E. The combined company will have 40% of revenue generated from derivatives and only 30% from cash equities.

A deeper analysis and valuation of the merger is beyond the scope of this write-up, but we're comfortable with owning the combined NYSE Euronext / Deutsche Boerse at a 30% discount.

CBOE Holdings (27% of the fund)

CBOE Holdings, also known as the Chicago Board Options Exchange, is one of the largest options exchanges in the world and the largest options exchange in the U.S., based on both contract volume and notional value of contracts traded. In addition to its core options trading business, the company provides marketplaces for trading futures contracts and cash equities through its subsidiary CBOE Futures Exchange and its affiliate CBOE Stock Exchange. Its leading products include equity options, index options and options on ETFs.

CBOE went public in June 2010. The company owns high-quality assets, some of which are unique and irreplaceable. For instance, CBOE currently has exclusive rights to list option contracts on some of the most widely recognized market benchmarks, including the S&P 500, the Dow Jones Industrial Average and the CBOE S&P Volatility Index (VIX).

However, CBOE suffers from several drawbacks. To us, the most important drawbacks are (i) competitive pressures, (ii) the ultimate expiration of certain of its exclusive rights and, last but not least, its (iii) high valuation.

On the competitive front, CBOE has steadily lost market share since the 1970s when it was the only U.S. options exchange. Today, CBOE controls roughly 25%-30% of the market, with NYSE Euronext, Nasdaq and Eurex's ISE being other major market participants. Its market share has also been steadily declining in the past two years, as we can see below (source: Jefferies):

These competitive pressures have led to stagnant revenue and profitability at CBOE. Revenue was roughly flat in 2010 when compared with 2009, and profitability down due to margin compression. Yet despite this mediocre operational performance, CBOE commands one of the higher valuations in the exchange sector, at 13x trailing EV/EBITDA and 10x 2011 EV/EBITDA.

The reason behind the healthy valuation is that CBOE is viewed as a leading takeover target. The company is substantially smaller than competitors such as CME, NYSE, ICE, Nasdaq, Deutsche Boerse, etc., yet offers an attractive asset to any exchange company that's looking to become a leader within the options exchange universe. However, its high valuation is also acting as a deterrent to a potential acquisition, given that acquiring CBOE would be materially dilutive in initial years for lesser valued prospective acquirers like Nasdaq.

If a takeover doesn't materialize, the stock has some downside. That said, buying CBOE at a 30% discount, which is what we are doing through our purchase of Urbana, makes the holding more acceptable.

Bombay Stock Exchange (15% of the fund)

Because the Bombay Stock Exchange (BSE) is not publicly traded, analyzing this ownership stake is a bit more difficult than the NYSE Euronext and CBOE holdings.

The Bombay Stock Exchange is one of the two major securities exchanges in India. The BSE is the weaker exchange, with high exposure to cash equities as opposed to derivatives. Derivatives exchanges are more attractive businesses than cash exchanges, because their clearing and settlement characteristics protect them from competition from "alternative trading systems" (examples are BATS or DirectEdge in the U.S.).

The BSE provides profit and loss statements on its website. In the year ended March 31, 2010, the company generated $64m of EBITDA and has generated a similar amount of annualized EBITDA in the most recent nine months. Unfortunately, the BSE does not provide a balance sheet, which makes it difficult to calculate the company's enterprise value. Based on discussions with Urbana management and other market participants, the Urbana's BSE holding is being valued at less than 10x EV/EBITDA, and perhaps as low as 7x to 8x. Earnings have held steady over the past year, though they have not been growing at as high a rate as we would like. Altogether, the valuation of the BSE appears reasonable.

Incidentally, another worthwhile data point is the price paid by other investors for stakes in BSE. Urbana announced in July 2010 that Soros purchased a stake in the BSE at a price comparable to Urbana's current BSE valuation.

While valuation is not a major concern, a more serious risk to the BSE holding is that the Indian government is considering legislation to prevent IPOs of any of the Indian exchanges. An IPO provides the most reasonable exit strategy for Urbana, and a postponement of the IPO date would likely lower the value of Urbana's BSE shares. The currently proposed legislation is based on a commissioned report that was released late last year, and we're regularly monitoring news with respect to the legislation.

Conclusion

In summary, we think Urbana features a relatively attractive risk-reward profile. Its portfolio holdings are reasonably valued, and the stock trades at a 30% discount to NAV. The investment manager is experienced, has a legitimate track record and has been aggressively repurchasing shares.

As usual, this post does not constitute investment advice or a recommendation of any sorts. Kerrisdale Capital may buy, sell or short any of the stocks mentioned at any time. We may be wrong; it would not be the first or last time.

Sahm Adrangi
Kerrisdale Capital Management, LLC
20 West 55th Street, 6th Floor
New York, NY 10019
Tel: (212) 792-9148
Cell: (212) 300-3452
Fax: (212) 584-8942

ABOUT

Kerrisdale Capital is a value-oriented and special situations investment manager based in New York. To inquire about our managed accounts, email us at info@kerrisdalecap.com.

LEGAL

This communication is for informational and educational purposes only and shall not be construed to constitute investment advice. Nothing contained herein shall constitute a solicitation, recommendation or endorsement to buy or sell any security or other financial instrument or to buy any interests in any investment funds or other accounts. Kerrisdale may hold positions in any of the securities mentioned. The sender has no obligation to update the information contained herein and may make investment decisions that are inconsistent with the views expressed in this communication. The sender makes no representations or warranties as to the accuracy, completeness or timeliness of the information, text, graphics or other items contained in this communication. The sender expressly disclaims all liability for errors or omissions in, or the misuse or misinterpretation of, any information contained in this communication.