STALLION ASSET
CREATING ALPHA

12-12-2016

CMP: Rs.1340 Weight: 5%

India's No.1 Commodity Exchange

STOCK DATA

Market Cap(Rs. cr)	6831
Average Daily Volume(Rs. cr)	21923
EPS(Rs)	8.36
ROE(FY17E)	13
52 week high/low	1420/720
Shares outstanding	5.09

KEY FINANCIALS (Rs. in Cr)

Y/E March	2013	2014	2015	2016
Revenue	645	440	333	333
Operating exp	209	195	135	158
EBITDA	436	245	198	175
Depreciation	31	34	27	25
Interest Expense	0	1	0	1
PBT & exceptional	405	210	171	149
Exceptional Item	0	0	0	67
Taxes	106	57	45	41
PAT	299	153	126	41

VALUATION : Great Business at Inflexion point, with multiple triggers like shift from Dabba market to MCX. MCX has increased transaction cost by 26% and the impact will be seen in the coming quarters. MCX will be launching Options in Q4 2017. MCX has multiple triggers and Financials can change dramatically going forward.

MCX

"What doesn't kill you, Makes you Stronger"

Thesis – MCX is India's largest Commodity Exchange with market share of 89%. It is a very simple business, the more the people trade on the exchange, the more revenue the company makes**.**

Why do we like MCX?

1) Shift from Dabba Market to MCX
2) Price Increase of 26% in October
3) Operating Leverage
4) Introduction of Options

MCX story can be divided in 3 Phases

1) **Phase 1 – Growth Phase** – Mcx Started Operations in 2003 and in FY 2013 did profit of 300 crores.
2) **Phases 2- Crisis Phase-**
   - Budget 2013 - Commodity transaction by ex-finance Minister P Chidambaram
   - July 2013- NSEL scam, Promoter jailed
   - Low commodity volume – 2011 saw massive increase in price of bullions like Silver, which then corrected by half and volumes decreased.
3) **Phase 3- Recovery**
   - Kotak Bank buy's Stake of Old Promoters
   - All Market Share loss Recovered

After demonetization the Shift from Dabba market (Illegal cash market) to MCX is inevitable. The Size of Dabba market is 3-10x the size of the current MCX volumes. Any Shift from Dabba Market to MCX with directly affect profits as no new cost would be involved. (Operating Leverage)

Globally in the Commodity Exchange business, it has always been a "Winners take all Game". The Commodity Exchange which has liquidity has more participants, which then increases liquidity and attracts more. (Networking Effect)

Financials at Glance

Particulars	GROWTH PHASE								CRISIS PHASE			POST CRISIS
	Mar-05	Mar-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16
Sales	29.76	90	165.58	173.66	212.45	287.38	368.89	545.11	523.96	340.67	222.49	234.93
Expenses	14.14	35.37	70.19	125.37	135.47	145.81	177.15	207.89	208.79	194.94	134.92	151.93
Operating Profit	15.62	54.63	95.39	48.29	76.98	141.57	191.74	337.22	315.17	145.73	87.57	83
Net Profit	11.12	45.64	93.04	105.27	158.02	220.62	172.82	286.19	298.64	152.76	125.05	41.83
ROE (%)	41.55	15.44	31.9	29.38	31.97	31.65	20.42	28.71	25.86	13.35	10.4	3.47

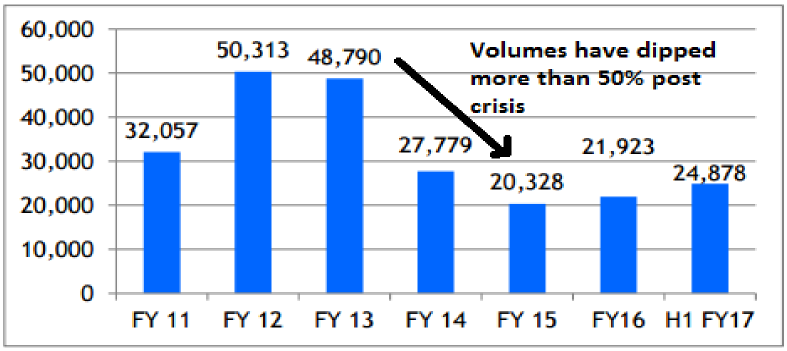
In FY 2016 MCX Did lower sales than the profit in FY2013 clearly suggesting that its at a cyclical low. The lower net profit of FY16 is mainly attributable to two exceptional items, namely (i) the aggregate loss of 61 Cr. due to diminution and provision on account of the investments in Metropolitan Stock Exchange of India Limited (MSEI) (formerly MCX-Stock Exchange Limited) and (ii) transfer of penalties to Multi Commodity Exchange Investor (Client) Protection Fund (IPF) for earlier fiscals (i.e. 2007-08 to 2011-12) amounting to 6 Cr.

History of MCX – MCX has seen massive ups and Downs in it journey of last 13 years. 2013 was the biggest drag it its history as with 3 Major Events happening consecutively in 2013.

1) Feb Budget 2013- Commodity transaction tax Imposed of 0.1%
2) July 2013- NSEL Scam broke out
3) Change in promoter and Management.

The company has struggled for last 2-3 years but still maintained its market share above 80% in the commodity market and in H2 2017 it increased to 89%.

AVERAGE DAILY VOLUME - single side (INR Crore)



Daily volumes had almost halved post the NSEL scam. During that period CCT was levied by the govt. on the transaction.

Why MCX?

1) Shift from Dabba Market to MCX
2) Operating Leverage
3) Price Increase of 26% in October
4) Introduction of Options
5) Strong Business Franchise
6) Strong Cash Flows with Zero Capital Requirements

1. **Shift from Dabba Market to MCX-** As per estimates the Dabba market was atleast 3-10x bigger than MCX pre demonetization. We did a research on ground level and spoke with a few Dabba Brokers and found out that the daily turnover is atleast 2 lakh crores in Dabba market v/s 25,000 Crores in MCX.

Whats is Dabba Market?

Dabba is illegal market, primary the trades are counterparty trades and not done on the exchange. The settlement happens in cash at end of every week. Majority of jewels use this for their hedging needs.

Why would people trade in 'Dabba Market' and not on MCX

	MCX	Dabba
Gold Price	30000	30000
Lot Size	1 KG	1 KG
Value	30 Lakhs	30 Lakhs
Brokerage %	0.02%	100/lot
Brokerage (INR)	600	100
Stamp Duty	30	0
Brokerage Service Tax (INR)	90	0
CTT (INR)	300	0
Exchange Charges (INR)	60	0
Total Charges	**1080**	**100**
Capital Gain Taxes	**30.00%**	**0.00%**

There is no capital gain taxes on profit made on Dabba Market as these profits are settled in cash and not disclosed to the tax authorities.

The cost of Transaction in Dabba Market is 1/10th the price of MCX.

Majority of Commodity traders like Jewellers or Steel trader in India understate their income to avoid paying taxes hence they avoid trading in the legal MCX Market.

After Modi's Move on demonetization we expect that the Dabba Market will face massive challenges due to shortage of currency and believe that a certain percentage of Volume will shift to legal MCX platform. (Dabba Market is 4-10x bigger than MCX and does a average turnover of 1-2.5 Lakh Crores everyday)

2. **Huge Operating Leverage –** Let's assume, MCX turnover Increases next year at people shift from dabba Market to MCX, Would the cost increase as well? **The Answer is No.** MCX will enjoy operating leverage as Nearly 2/3 of the MCX's total operating cost are fixed hence any increase in volumes will translate into profits. **Hence if revenues Increases by 20%, Profits will Increase a lot more.** Employee cost and software charges are the main operating expenses for the company (each being 20% of the total expense).Employee expense is fixed whereas software charges are partially fixed.
MCX's Software charges are 1.5 Cr. of fixed fee (fixed portion) and 10.3% of the transaction revenue (variable portion).Hence MCX's profit can grow disproportionately to revenue.

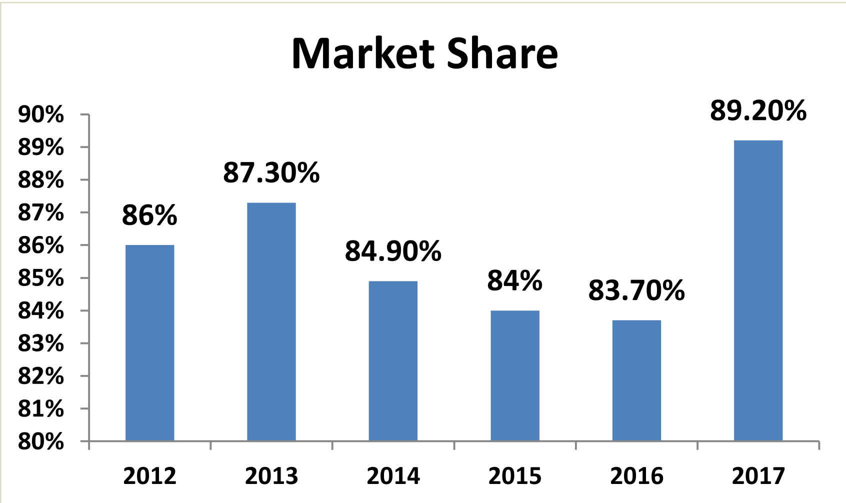
3. **Price Increase of 26% in October – *"The Most Important thing in evaluating a business is Pricing Power" – Warren Buffet*** .As per the circular dated 29th September 2016, MCX has hiked the transaction charges with effect from **1st October 2016.** The effect on the revenue will be visible in the current Quarter. There will be zero effect on trading because of increased pricing, showing that MCX has massive pricing power.

	Non Agri Commodites		Agri Commodities	
	Per 1 lakh of turnover(INR)			
	Less than 350 cr	More than 350 cr	Less than 200 cr	More than 200 cr
Oct-16	2.6	1.75	1.75	1.75
Feb-14	2.1	1.4	0.75	0.5

*** 350 Crs turnover per trading member/day**

4. **Introduction of Options-** MCX is expected to launch options on select commodities next quarter, as slowly over the next 1 year introduce it in all products. Options will take a year to develop, but we expect large volumes from the options space only from 2018. There is no Dabba Broker who offers services for Options and hence there options volumes are expected to be high in MCX. In NSE, options contributed 81% of the total market volumes. We expect options to dominate the commodity derivatives market as well in next 3-5 years.

5. **Strong Business Franchise-**



MCX is a strong brand in the market, even after crisis in 2013-2015; the company's market share never went below 83%. **Commodity Exchange is winners take all market as you need counter party liquidity.** Trading members chase liquidity and wherever there is liquidity they trade there.

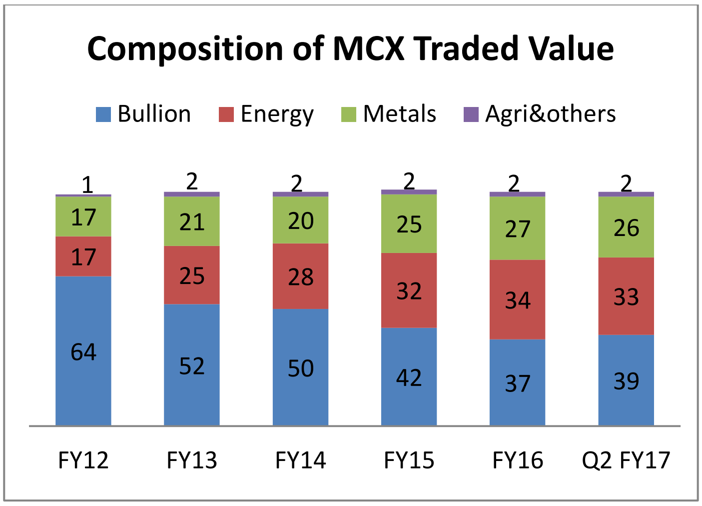
***2017 Data is for the first six month of FY 2017**

MCX has a Strong Competitive advantage or Moat around the business (Networking Effect)

What is Networking Effect- The more participant come the more the liquidity and lesser the bid-ask spead. The networking effect occurs when the value of a particular good or service increases for both new and existing users as more people use that good and service. Example of this is Stock Exchanges, Ebay, Facebook, Twitter etc.

6. **Strong Cash Flows with Zero Capital Requirements- MCX** is an asset light business model. If volumes of MCX go up 3 times, it cost doesn't go up subsequently. In last 11 years it has always had a positive operating cash flow consistently improving with nominal Capex requirements. The company has never diluted, infact even when it came with its IPO it was an offer for Sale with existing shareholdings.

Commodities Traded on the Exchange -



Products		
Metals	**Energy**	**Agri-commodities**
Bullion	Crude Oil	Cardamom
Aluminium	Natural Gas	Cotton
Copper		Crude Palm oil
Lead		Mentha oil
Nickel		
Zinc		

Risks-

1. **NSE as a universal exchange –** NSE till now doesn't trade commodities per se, but they have their own depositories and clearing corporations that can cater to commodities traders as well. If they enter into commodities as well, then it is a threat for MCX. As already mentioned in the report, this is a "'Winners take all market', most of the traders are on NSE Platform for equities, debt and currencies, they might prefer to shift to NSE for ease of transacting

2. **Price Risk-** Since the transaction fees are charged on the value of the contract (not volumes), hence any sudden price change of the commodities traded can have a larger impact on the topline**.**

3. **Concentration risk**- Bullion and energy contributes majority of the total MCX volumes hence any sharp decline in price will affect the volumes of the company.

Valuation – There are multiple triggers for re-rating of valuation for MCX. 66% of MCX cost is fixed is nature i.e. Increase in Volume will have a non-linear impact on profits. We believe MCX will do a profit of 160-170 Crores in FY 2017 current quoting at 40 Times FY 2017. It is Important to understand that MCX is at inflexion point right now and earnings can change rapidly. Our Estimate is that the Dabba market's daily turnover is 2,00,000 Crore in India whereas MCX does about 25,000 Crores, even if 10% of this turnover shifts to MCX, the profits will go up 2.5x in FY 18. We exactly don't know how big the Dabba market is, and how much will shift to MCX, but we know that a small shift in turnover from Dabba market to MCX will change the fortunes of the company. MCX was trading at these levels pre-demonetization as well without discounting the shift from Dabba to MCX. We believe head we win a lot, tails we don't lose much type situation.

NSE Listing can help re-rate MCX. NSE is expected to list within the next 6 months

MCX vs Global exchanges- Globally Stock Exchanges are a very profitable business' worldwide due to their asset light model and networking effect of liquidity. The Valuation of global exchanges is between 21-30 PE. MCX trades at higher valuation as it's at a major inflection point.

Name	Market Cap (USD Million)	P/E	ROE	P/B
Developed Markets				
Hong Kong Exchange	31193	40	20	7.77
Japan Exchange Group	8674	25	16	3.93
Singapore Exchange	5473	24	24	8.92
CME Exchange	41550	29	7	1.97
Intercontinental Exchange	34660	24	10	2.28
Developing Markets				
Bursa Malaysia Bhd	1176	25	25	6.07
Bolsa Mexicana	783	21	15	2.91
MCX	1003	40	13	4.76

** Data taken from Morning Star and hasn't been verified.

Conclusion - MCX was fraught with challenges since past couple of years with its promoter, FTIL, being declared not "fit and proper" to run the exchange post NSEL fallout leading to entire top management rejig. Moreover, imposition of CTT had an adverse impact on trading volumes, coupled with sharp fall in commodity prices. Despite such turmoil's, the company emerged unscathed maintaining market leadership (with >83% market share) bearing testimony to its underlying business strength. Infact, the model has evolved much stronger with experienced management backed by strong financial partner (Kotak). Demonetization will curb free flow of 'illegal cash' and we expect that there will be a shift of trading from the 'illegal Dabba market' to MCX.

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Disclosure - Amit Jeswani & Family have no positions.

Analyst Disclosures: Positions held –No– Juhi Shah

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