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Capital Management

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CBOE

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Thesis

Unlike most financials, CBOE has a fairly straightforward business model. Even without a full understanding of complicated derivative strategies, an analyst can easily model this business. With monthly volume updates and daily information on trading statistics and market share (on its website), any analyst can track a real-time tally of CBOE's transactions. While the commission rate on these products varies, it is essentially a transaction-based business model. Average Daily Volume (ADV) multiplied by commissions or Rate per Contract (RPC) is an excellent proxy for revenue. Expenses grow, but only at a modest annual rate. Excluding deal costs, current expectations by management for expense growth remains muted in the low single digit range. Some brokerages depend heavily on FICC trading, which is unpredictable and 1x in nature. Unlike most financials, CBOE's business model can be built and dissected in an Excel spreadsheet. It is predictable, sustainable and recurring in nature. We believe the derivative exchanges are the ultimate business toll-keepers. We prefer these type of predictable models, as opposed to the wild up's and down's of cyclical businesses. As shareholders, we like the position of benefitting with higher volatility, regardless of whether prices increase or decrease.

Cyclical vs Secular - The Energy Sector:

As we get older, we have become less and less a fan of roller coasters. Our kids love the craziness of SheiKra, Cobra's Curse and Montu at Tampa Bay's Busch Gardens and we certainly appreciate the endorphin rush of these rides. The energy sector represents roughly 7% of the S&P 500 index. In 2016, this was the single best performing sector, up an impressive 24%. So far in 2017, energy is down (10%), making it this year's worst performing sector. Last year, OPEC (the Organization of Petroleum Exporting Countries) introduced production cuts, which boosted oil prices. OPEC has met again and decided to extend this agreement to limit its production. Where we are on this cyclical roller coaster is unknown. We prefer to avoid parts of the market rife with uncertainty and geopolitical dangers. The only prediction we are confident making about the energy market is that prices should be volatile. There are simply too many factors that determine price, outside of our area of expertise or knowledge base. We do not profess to have any true understanding in the inner circle of Saudi Arabia or their middle eastern foes Iran. Saudi Arabia is looking to IPO its crown jewel – Saudi Aramco - late this year or early next year and would love to see higher prices to boost that valuation. Speculation is that it could generate $2 trillion for Saudi Arabia, which will help it sustain its expensive welfare state (and fight its nemesis Iran). Iran and Russia are somewhat strange bedfellows, but both continue to pump record amounts of oil to boost current revenues. In addition to this murky outlook, the US is reporting varying levels and stockpiles of oil while China is experiencing less demand for many commodities ranging from steel, iron and oil.

These uncertainties perfectly highlight why we avoid investing in commodities and cyclical industries. The energy business is not only a capital-intensive business, subject to costly maintenance, but it also has multiple geopolitical factors that tend to wildly swing prices. We fail to see the advantage of investing in cyclical markets, where there is limited ability to add value.

Volatility:

We focus our attention on secular, predictable and recurring revenue business models. To further our point, we prefer to gain our "energy exposure" through the derivative exchanges. While these companies are classified as ***financials***, one could easily label these exchanges ***technology*** companies. CME Group (ticker CME) and Intercontinental Exchange (ticker ICE) are the two dominant exchanges where energy is globally traded. Both specialize in a key energy product, with CME dominating WTI crude and ICE controlling the Brent crude market. 15% of CME's total trading volumes and 19% of its total revenue are generated in the energy sector. The important energy sector represents 23% of ICE's total revenue. Both generate transaction-based revenue, based on the amount of hedging companies decide to make. Whether you are a user of energy (ie: Southwest Airlines) or a producer of energy (ie: Exxon), volatility in energy prices can endanger your business. Being able to hedge and lock-in key components of costs can be critical for future results.

High Barriers to Entry:

The VIX is a measure of implied volatility derived from S&P 500 option prices. Often referred to as Wall Street's "fear gauge", the VIX typically goes up when the market goes down. The VIX is a proprietary product that is only traded on the CBOE. In our opinion, this franchise is the ultimate "moat around the franchise". Unlike traditional options or equities, which can trade on multiple exchanges, there are imperviously high barriers to entry when it comes to proprietary products. This is a clearly a durable competitive advantage. For VIX trading, CBOE will permanantly have 100% market share.

Monopolies:

In addition to its proprietary VIX product, CBOE has the license to trade S&P 500 options. The S&P's 500 Index, often used quoted as the SPX, is the best and broadest index of US equities. It has become the world's leading benchmark for institutional investors and the only place to trade it is on the CBOE.

The International Securities Exchange has made numerous attempts at listing options on a SPX equivalent. The Supreme Court declined to hear the case, keeping CBOE is full possession of this valuable asset. CBOE is the sole market for options on the SPX, as well as the Dow Jones Industrial Average (DJIA). CBOE owns this exclusive franchise through 2033. Before the BATS acquisition, these valuable contracts generated nearly 2/3rd's of CBOE's transaction fees and over 1/3rd of its total trading volume. After battling rival exchanges, former CEO and Chairman William Brodsky said "We are vindicated after more than six years of lengthy and unnecessary litigation that the highest court in the land has validated our position and the intellectual property rights of index providers". What he could have said was he was pleased that CBOE got to keep its monopoly.

Transaction-Based Businesses:

There is a great saying in the exchange industry that "volume begets volume". When an exchange creates the de-facto location to trade any product (equities, interest rates, commodities, energy, foreign exchange), an long-term and nearly impregnatable moat is created. As more volumes come, this exchange will have the best liquidity. The tightest bid / ask spreads attracts both existing and new buyers and sellers. Whether somebody is a natural hedger or a simple speculator, it always will seek the location of best execution. With proprietary products, like the CBOE's VIX, a wonderful, virtuous cycle can be created. Volume begets volume. Liquidity begets liquidity. This continuously builds upon itself and is a perfect example of what we look for in an investment.

With the VIX was recently below 10, at its lowest level since 1993. Many market "experts" were stating that some investors are being too complacent. Some fear that there is not enough fear, considering all the world's worries. Then crack! We experienced a massive swing in volatility on Wednesday May 17th. The market was ignoring many of the controversies emanating from Washington DC and the Trump administration. We have seen a rise in global populism, potential Russian interference in our election, multiple European debt crises, a near hard landing in China, a commodity-driven emerging market currency issue, de-stabilization and riots in Venezuela, continued middle eastern fighting (especially in Syria) and escalating tensions on the Korean peninsula. All of these issues were shrugged off without interrupting the market climbing to all-time highs. Then, DC issues began to create worries that tax reform and financial de-regulation may not happen. In our opinion, the market was not reflecting these global worries, because it is more focused on the positives occurring in our economy.

Management Team / Allocating Capital:

From its IPO in 2010, CBOE had been fairly conservative. Its generated solid free cash flow and it was focused on returning it to its shareholders. This took the form of buying back its stock and especially towards returning it via dividends. This changed dramatically when CBOE decided to acquire BATS, announced on 9/25/16 and closed on 2/28/17. While we are only a few quarters into this deal, the changes at CBOE are noticeable. CBOE was in need of an improvement on the technology front and BATS provides it an opportunity to streamline and improve upon its core platform. There are large synergies to capture and this deal helps to diversify CBOE's business and profits. We consider this large, but transformative deal to be a wise use of our capital. Not to mention, this deal will ultimately be quite accretive.

Many expect a $0.60 lift to EPS, but that is likely conservative. In 2017, revenue and EPS are expected to grow significantly at 55% and 42% year-over-year. This is obviously due to the inclusion of BATS. However, looking at 2018, one can begin to understand the steady-state growth rate of CBOE. Estimates are calling for mid-teens growth in revenue and EPS. If CBOE can generate $4.25 in EPS and keep its current multiple, one could expect ~ 15% upside in the stock. We would anticipate management using its free cash flow and nearly 3/4rd's of a billion dollars of EBITDA to paydown debt levels. We would expect the dividend yield of ~ 1% to continue to climb for year's to come.

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Numbers, not News:

Quoting the Democratic strategist James Carville, "It's the economy stupid"! Research has proven that the stock market best correlates with the direction of earnings. Examining 2nd quarter 2017 results proves this point. We are steadily improving our growth rates, inflation is tame, unemployment is at record lows, balance sheets are flush with cash and there is a strong possibility for tax reform in 2017. Year to date, the stock market is up mid-single digits because it reflects the improving global fundamentals, as well as expectations for easing regulation and earnings boosting tax cuts. 463 of the S&P 500 members or 93% of the index's total membership has reported 1st quarter results. So far, year-over-year earnings for these companies are up +13% on 7% higher revenues. Sentiment remains positive, with 73% of these companies beat earnings estimates and 66% exceeding revenue expectations.

We will continue to spend our time doing fundamental research and analyzing key economic drivers impacting the markets. While there is the potential negative fallout from the political issues emanating from Washington DC, we continue to focus on the positive, earnings growth signals we see in the economy. The market is wrestling with uncertainty regarding relaxing burdensome regulations and the proposed tax overhaul. We still believe that these reforms happen, but their timing is less certain. While the media seems to be relishing these headlines Washington is producing, the market is more concerned with underlying economic trends. The volatility in the current administration might roil the markets on any given day, but we do not believe this "trumps" the improving overall economic picture.

As long as the market continues to move higher, volumes will continue to be solid at CBOE. In the event of a sudden, volatile event, the VIX will explode higher. CBOE will see huge volumes and ultimately will benefit from this type of environment. We liken it to a mini-hedge on the upward sloping equity market.