

Opportunity abound

Financial Technologies promoted **Multi Commodity Exchange is a market leader** in India's burgeoning commodity derivatives market. Its journey of becoming a dominant commodity exchange with **86% market share** has been fascinating. Interestingly, the next largest player has only 10% market share.

The domestic commodity derivatives market after being opened up in 2003 has witnessed **robust 85% CAGR** in turnover. This was driven by widening commodity portfolio and rising interest in hedging and speculation due to increasing price volatility. In the aforesaid time, **MCX registered a much stronger 200% CAGR in its turnover**.

MCX's **strategic initiatives** of building a globally referable commodity portfolio, product innovation, global strategic alliances and cutting edge trading technology helped it garner a dominant market share. More importantly, **trading depth/liquidity has substantially improved** and remains a cornerstone of its dominance.

Aided by increasing turnover and fixed cost leverage, MCX's **OPM has seen tremendous expansion**; doubling to 63% over FY08-12. With further room for capacity utilization improvement, **margin will most likely be sustained at elevated levels**. Lower capital requirements suggest stable to improving cash flows in future, possibly translating in higher dividend payouts.

The **opportunity for growth** remains huge given a much lower derivative turnover/total physical flow multiple of India versus the developed markets. For instance, gold turnover on MCX is just 15x of the total physical flow in the economy versus 75-85x in the developed economies. Similar is the case for crude, aluminium, copper among others. Additionally, **positive regulatory announcements (passage of FCRA bill) could open host of growth avenues**.

We conservatively estimate revenue/earnings to witness 14%/15% CAGR over FY12-14 considering recent moderation in revenue growth. Current **valuation of 17.5x FY14E P/E is inexpensive for a secular growth story like MCX**; also attractive in comparison with emerging market peers. **Initiate with BUY and 9-month TP of Rs1,510**. Company's investment in MCX-SX can provide further upside to our price objective.

Financial summary

Y/e 31 Mar (Rs m)	FY11	FY12	FY13E	FY14E
Revenues	3,689	5,262	5,791	6,833
yoy growth (%)	28.4	42.6	10.1	18.0
Operating profit	1,918	3,347	3,717	4,503
OPM (%)	52.0	63.6	64.2	65.9
Reported PAT	1,734	2,867	3,242	3,833
yoy growth (%)	(21.5)	65.4	13.1	18.2
EPS (Rs)	34.0	56.2	63.6	75.2
P/E (x)	38.8	23.4	20.7	17.5
P/B (x)	7.9	6.7	5.7	4.9
EV/EBITDA (x)	33.3	19.1	17.1	13.6
RoE (%)	22.5	32.6	29.9	30.1

Source: Company, India Infoline Research

Rating: BUY

Target: Rs1,510

CMP: Rs1,318

Upside: 14.7%

Sector: Financial Services

Sector view: Neutral

Sensex: 18,694

52 Week h/l (Rs): 1,426 / 838

Market cap (Rscr): 6,722

6m Avg vol ('000Nos): 241

Bloomberg code: MCX IN

BSE code: 534091

NSE code: MCX

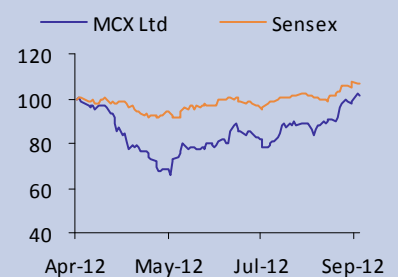
FV (Rs): 10

Price as on Sep 25, 2012

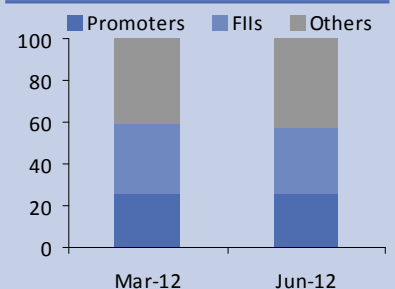
Company rating grid

	Low → High				
	1	2	3	4	5
Earnings Growth			■		
Cash Flow				■	
B/S Strength				■	
Valuation appeal			■		
Risk		■			

Share price trend



Share holding pattern



Research Analyst:
Aniruddha Mehta
research@indiafoline.com

A dominant industry player on the back of blistering growth

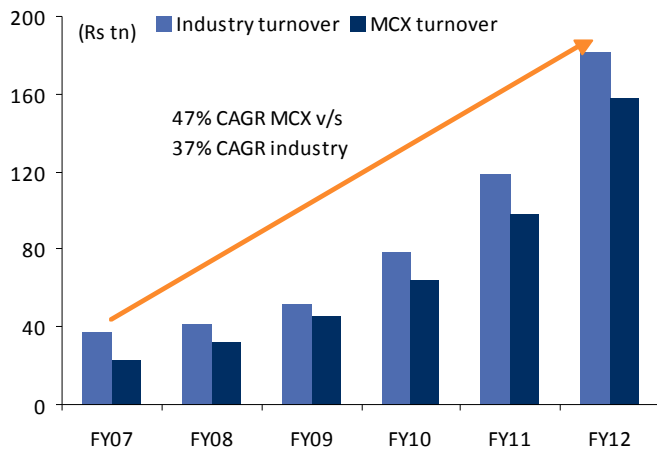
Multi Commodity Exchange (MCX), one of the first movers in the Indian commodity exchange industry, is a firmly entrenched player with 86% share in the industry trading turnover. Its position has remained dominant for major part of its existence with its nearest competitor NCDEX having only 10% of the market-share. Within the commodity basket, company's strong focus on non-agricultural commodities like precious metals, energy and base metals has resulted in MCX becoming the world's largest in Gold/Silver, second largest in natural gas and third in crude oil in terms of number of contract traded. While the commodity industry turnover in India (since its liberalization in 2003) witnessed a CAGR of 85% over FY04-12, the growth at MCX has been spectacular at 200%+ CAGR in the same period. Also, its market share has increased from ~60% in FY07 to 86% (in terms of value of commodity traded) in FY12. The market leadership is even stronger at 95%+ in its focus commodities.

MCX is a market leader in India with 86% market share in FY12

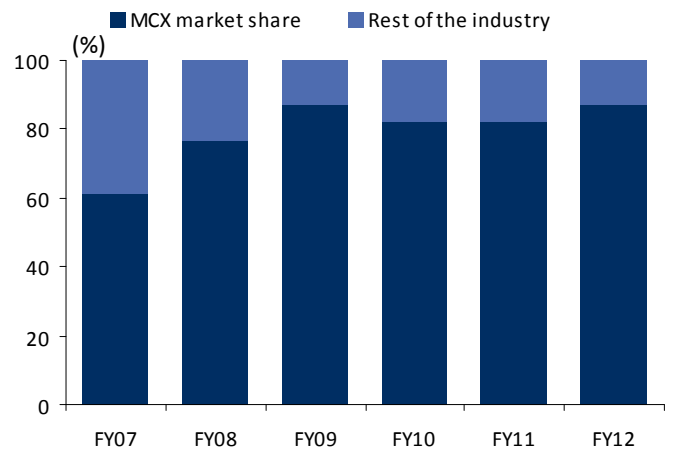
For CY11, in terms of the contracts traded globally, MCX is 1st in gold/silver, 2nd in natural gas and 3rd in crude oil

Since inception, MCX has grown much faster at 200% CAGR versus 85% for the industry

MCX growing faster than the overall industry

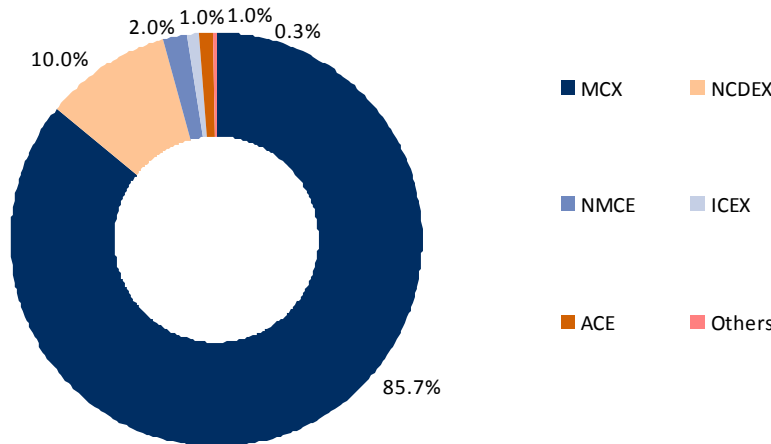


MCX market share improved substantially over FY07-12



Source: Company, India Infoline Research

Market share distribution amongst various Indian commodity exchanges



Source: Company, India Infoline Research

A variety of factors – both industry specific and those attributable to MCX’s sound strategy have influenced stupendous growth seen at the exchange. These include:

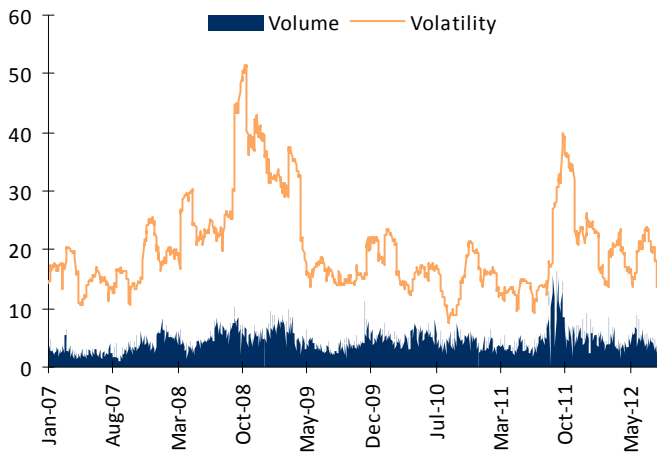
Increased price volatility in key commodities in MCX portfolio

The trading turnover in any derivative market is highly correlated to the price volatility of the underlying asset. Similarly, strong price volatility in the key commodities baskets of energy, precious and base metals has resulted in robust volumes in the past 4-5 years for MCX as well as the industry. Also, in precious commodities like Gold and Silver, strong upward trend in prices in past decade have also resulted in increased trading turnover in them. The charts below further validate the linkage between the volatility and volumes.

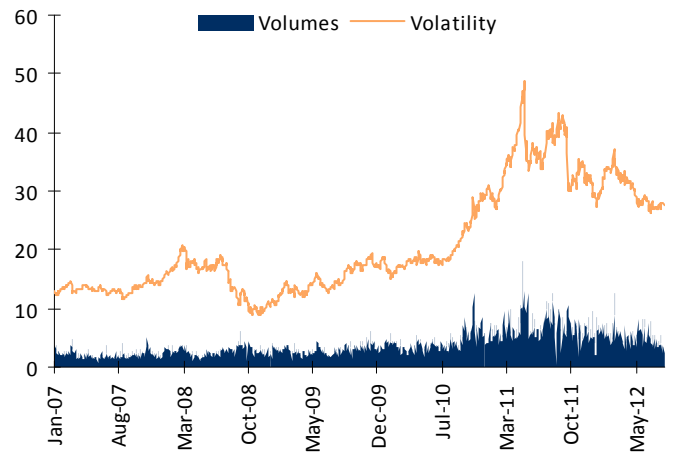
There is a high correlation between the volatility of the underlying assets and the turnover in the derivatives market

Trend of volumes versus volatility of top 4 commodities at MCX

Gold

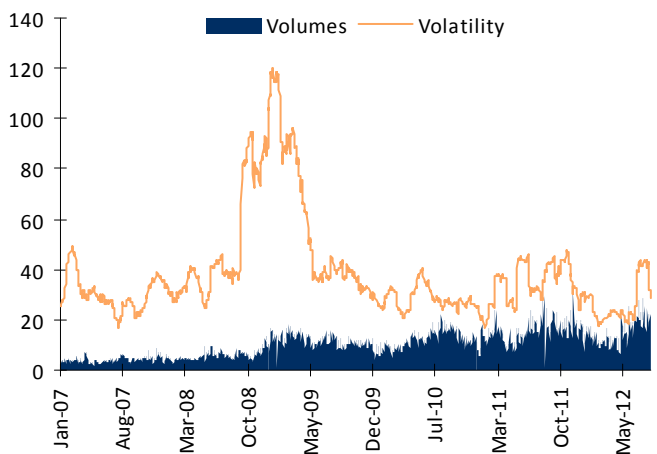


Silver

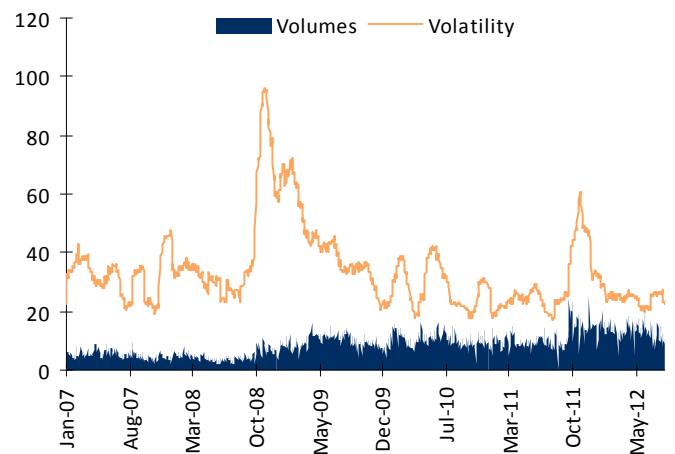


Source: Company, Bloomberg, India Infoline Research

Crude



Copper



Source: Company, Bloomberg, India Infoline Research

Steps towards removal of regulatory barriers

Progressive removal of regulatory barriers for commodity futures trading by the Indian government with focus on increasing competition, improving participation (investor education and higher numbers of commodities for trading) has further resulted in improved trading turnover. For instance, FMC- the regulatory body for Indian commodity markets lifted the ban on gold/silver trading after four decades in 2003. It has also improved competition in the commodity exchanges market by introduction of five national commodities (besides sixteen other regional exchanges). Other important regulatory initiatives include introduction of Exchange for physicals (EFP), Alternate futures settlement (AFS), and expanded delivery period among others. Though the passage of the current FCRA bill has been delayed in Parliament, we believe the clearance would materially ease the regulatory hurdles.

Various positive regulatory steps have facilitated the strong growth in the Indian commodity derivatives market

Product innovation, strategic alliances and strong liquidity at MCX

While the aforementioned mentioned factors have positively impacted the turnover across the commodity exchange, the key factors that have led to the meteoric growth in volumes at MCX and its resultant market leadership are:

Specifically to MCX, its product innovation, strategic alliances, robust technology platform have resulted in sticky liquidity

Product innovation

Since inception (FY04), MCX has expanded its product portfolio from 15 to 49 currently. One the leading factors for the strong growth at MCX is the introduction of these products by customizing it to the requirements of the Indian market participants. For instance, smaller lot size/ customized gold contracts like Gold petal/Gold mini have successfully been able to cater to domestic (esp. retail) requirements and led to the strong volume traction. Introduction of the new gold petal contracts in Q1 FY12 has already resulted it constituting more than 40% of total gold trading turnover at MCX currently. Other products like Silver micro/mini futures, copper/nickel futures too are among the top 20 metal futures contract globally by volumes. Going further, proactive investment in other products like rain indices, freight indices, commodity indices, options among others are expected to lead to further volume traction.

Introduction of products continually customized to domestic requirements have helped to gain faster volume traction

Strategic alliances

MCX has entered into strategic alliances with international exchanges like NYMEX, LME amongst others to use their commodity prices as a benchmark for settling futures contracts for the respective commodities in India. The prices of commodities on these exchanges are global benchmarks and hence make these alliances highly desirable by market participants (which include companies with global presence).

Key alliances/MoUs of MCX

Alliance with	Description
NYMEX	Use of Nymex prices as benchmarks to settle contracts; promotion of trading in Nymex products
LME	Use of LME non ferrous metal prices as benchmarks to settle contracts
LIFFE Administration and Mgmt	Use IP in Robusta coffee and white sugar contracts to settle contracts
Shanghai futures Ex.	Knowledge sharing and promote devp. Of commodity markets
The Baltic Ex.	Use of freight futures data as benchmarks to settle contracts
Taiwan Futures Ex.	Knowledge sharing and promote devp. Of commodity markets

Various strategic alliances with global exchanges like Nymex, LME among others have resulted in higher member participation

Source: Company, India Infoline Research

Robust trading environment

FTIL, with its deep domain expertise in development and deployment of exchange-related software provides MCX with its online trading platform. Technology, a key differentiator for an exchange, has been bolstered for MCX by this robust, transparent and difficult to replicate platform. MCX trading platform which has been built on relatively newer technology base makes it highly scalable as compared to older exchange technologies based on mainframe. Even with its current technology infrastructure, MCX trading platform can cater up to 10mn transaction per day as compared to current traffic of ~2mn (peak level). This headroom also provides operating leverage as additional transaction can be accommodated without any major cost outlay. Due to technological support from FTIL, the continued implementation and deployment of newer technologies/regulatory policy changes/newer products can be quickly incorporated. Greater accessibility due to online trading system, immediate trade execution, anonymity and price transparency have led to a better price discovery resulting in MCX prices becoming a benchmark in India especially in its top 5-6 commodities.

Technology backing from parent FTIL has given MCX a robust, scalable and difficult to replicate platform- a key differentiator for any exchange

Currently MCX platform can cater to 10mn trades per day versus only 1.8mn of peak trades achieved as yet

Sticky liquidity in its key commodity offerings

MCX's early mover advantage, product innovation, strategic alliances and best-in-class trading environment has facilitated it to capitalize on the positive structural as well as regulatory changes impacting the Indian commodity market. The subsequent volume expansion in precious metals, non-ferrous metals, crude oil among others has resulted in increased market depth/liquidity (lower bid-ask spreads) and subsequently lower market impact cost- absolute essential for an exchange. The table below shows the minimal bid ask spread for the leading four commodities at MCX.

Market depth/liquidity for key commodities at MCX is the best. This has resulted in volume stickiness and MCX prices have become benchmarks.

Spreads for key commodities on MCX

	Expiry Month	Bid (Rs)	Ask (Rs)	LTP* (Rs)	Spread	Spread as % of price	Spread in bps
Gold	5th oct 2012	31,758	31,762	31,760	4	0.013	1.259
Silver	5th Dec 2012	63,610	63,615	63,611	5	0.008	0.786
Copper	30th Nov 2012	454	454	454	0.05	0.011	1.101
Crude Oil	19th Oct 2012	5,261	5,262	5,262	1	0.019	1.900

Source: Company, India Infoline Research

*LTP-Last Traded Price

Broad-based and balanced portfolio of commodities

The stupendous growth in commodity trading volumes at MCX is also attributable to the portfolio of commodities traded on its exchange platform. This is due to 1) Diversity among the key commodities as a result of which lower volatility (and hence volumes) of a subset of commodities tends to get offset by higher volatility in other commodities thereby minimizing any material impact on the total turnover. 2) Non-agricultural commodities, which form most of the volumes at MCX, are not hampered by frequent regulatory interventions largely prevalent in agricultural commodities.

MCX commodity portfolio lends well to lower turnover volatility due to lower correlation as well as no material contribution from Agri-based commodities

MCX has a broad-based commodity portfolio of 49 commodities which lends positively to diversity of volumes and has helped to sustain and grow the turnover. The top four commodities by turnover at MCX viz. Gold, Silver, Copper and Crude form 85%+ of MCX's turnover and have shown lower price correlations (barring gold-silver pair). This has resultantly helped the company's turnover to continue to grow faster than the industry. For instance in FY08, the slow growth in volumes of gold and silver was offset by 150% growth in Crude oil (16% of turnover). Similarly, 9% de-growth in gold turnover in FY10 was offset by 130% and 40% growth in copper (15% of turnover) and silver (21% of turnover) respectively. Over CY05-12 (YTD), the correlation (or the lack of it) between these commodities substantiates the same.

Correlation across key commodities in MCX

Commodity Pair	Correlation (over CY05-12YTD)
Gold – Copper	0.63
Gold – Crude oil	0.57
Silver – Copper	0.72
Silver– Crude oil	0.62
Crude oil– Copper	0.70
Gold – Silver	0.93

Source: Bloomberg, India Infoline Research

Correlation between key commodities (except precious metals pair) has been low resultantly lowering volume volatility

MCX has also not been materially impacted by regulatory intervention in the commodity market due to a conscious decision to limit exposure to Agri-based commodities (top 6 commodities forming 90%+ of MCX's turnover are non agri-based). Most the regulatory directives, since CY03, in terms of open position/margin/delivery have been to control speculation-driven price increases in agri-based commodities and have subsequently more significantly impacted MCX peers like NCDEX/NMCE. This is further evidenced in the recent indication by the GoI on possibility of removal of low output commodities like guar seeds/guar hum, mentha oil to reduce speculation-led price increases in the same. Also the seasonality factor associated with these commodities does not have material impact on the exchange turnover and possibly leading to lower volume variation.

Majority of the regulatory intervention has been for Agri-based commodities which are not a focus for MCX and hence have not impacted volumes

Turnover concentration in certain commodities – is it a concern?

A majority of MCX's turnover is concentrated in four commodities viz. Gold, Silver, Crude and Copper comprising nearly 85% of the total turnover. Though this concentration is high, a look at the composition at various older exchanges globally also reveals similar concentration. The higher concentration hence is not expected to lead to any material negative impact.

Concentration of turnover in 4-5 commodities as seen at MCX is also seen at other mature developed market indices too

Concentration of commodities in key exchanges globally

Entity	Commodities	Approximate volume share
COMEX	Gold, Silver	84%
NYMEX	Crude Oil, Natural Gas	81%
CBOT	Corn, Soyabean, Wheat	71%
ICE	Brent Crude, Gas oil	57%

Source: CME group, ICE group, India Infoline Research

Strong opportunities can lead to another growth fillip

Benefited by the structural tailwinds in the commodity derivatives market along with the product innovation at MCX, its growth has shown robust up-tick in both turnover and revenues since its inception. This is evident in strong 25%+ operating revenue CAGR over FY07-12. More recently, though, the volumes have subdued due to lack of trigger in global commodity markets and growth slowdown in the domestic economy. This is evident in the slower turnover growth of 9% in Q1 FY13 versus 60%+ last year. Nonetheless, the nascent stage of Indian commodity market as well as India's long term growth story will help sustain volumes going forward. Also, as validated by the 43% CAGR in turnover over FY08-10 – the period affected by the global financial crisis, any volatility created in globally referentially commodities like Gold, Silver, Crude oil due to ongoing macro uncertainty should lead to improved volumes for MCX.

Despite a slower start to FY13 in terms of volumes. India's nascent commodity derivatives market should continue to grow in medium – long term

Nascent Indian commodity derivatives provides strong headroom for growth

As India grows, the demand for hedging of commodities should naturally go up boding well for derivative trading in these commodities. This is visible in mature exchanges in developed markets, wherein the turnover of commodity derivatives are a much higher multiple of the physical flow of commodities in these markets as compared to India. For instance, in CY10, the ratio of total futures turnover in Gold at MCX is 15x of the total physical flow in India as compared to a ratio of 85x for COMEX Gold. Similarly, the same ratio for Aluminium is ~6x in MCX as compared to 97x in the case LME Aluminium contracts. Also, the turnover of only metals and energy at CME group (for CY11) is nearly 100x of the total turnover at MCX further validating the our strong headroom thesis.

Derivatives turnover/ physical flow multiplier for commodities like Gold/Aluminum/crude/palm oil are much lower in India as compared to developed markets

Key regulatory changes – Potential game changers

✧ *(Re)Introduction of options trading in commodities* - A significant part of the hedging of assets is done through options derivatives. For instance, globally the proportion of options used as a derivative instrument in CY11 was nearly 50%. But in India, due to banning of options from commodity derivative market (since 1952), volumes have been restricted to futures. A look at the strong growth in options volumes at NSE (market leading securities exchange) also shows the robust appetite for options as a derivative instrument.

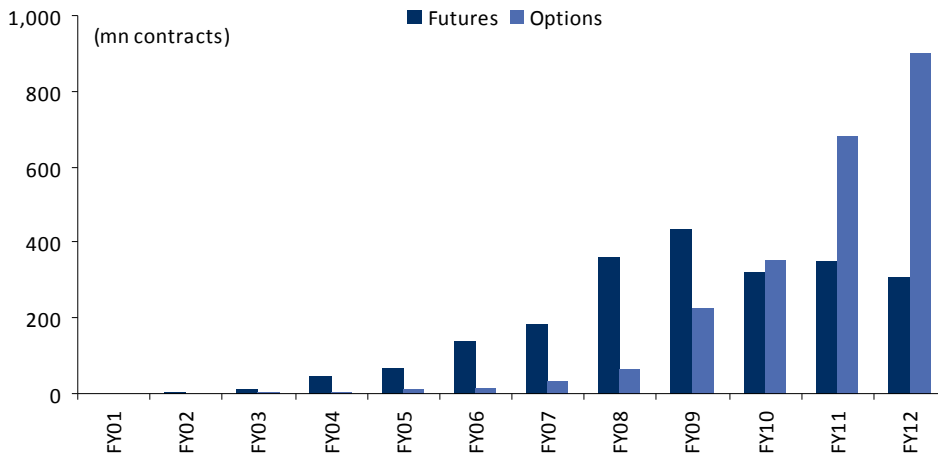
Options that form ~ 50% of global derivatives market are yet to be allowed in Indian commodity markets

Global derivatives volumes in CY11

Derivative instrument	Volumes (in mn contracts)	% of the total volumes
Futures	12,050	54
Options	10,375	46

Source: Futures Industry Association (FIA)

Volume growth in options has been spectacular at NSE



Expansion of commodity definition to include intangibles like weather, freight as well as indice futures trading is another driver for future growth

Source: NSE (equities), India Infoline Research

Regulatory approval to allow options trading (a part of Forward contracts amendment bill 2010*) should provide better trading opportunities to more risk averse investors esp. Retail participants and subsequently leading to market expansion and better volumes on commodity exchanges.

Allowance of financial institutions to participate in commodity derivatives can have material positive impact on derivatives turnover

- ❖ *Expansion of product basket* - Further improvement of products basket should provide strong fillip by expanding the addressable participant base. Introduction of commodity indice futures, freight futures, weather indices and other innovative products are expected to help achieve the objective. MCX’s commodity indices like MCX COMDEX, MCX Metal, MCX Agri as well as its alliances for eg. with Baltic Exchange for freight futures are expected to lend traction to the exchange volumes as and when they are introduced for trading.
- ❖ *Institutions’ participation in commodity derivatives* - Banks and other financial institutions like mutual funds, pension funds etc. are yet not allowed to trade on Indian commodity exchanges. These participants form a sizeable chunk of the volumes in developed market commodity exchanges. For instance the participation profile of CME group shows that the participation from non-retail/corporates is 85%+.

While an increase in participation by banks and other FIs can lead to higher volumes, sizeable amount of money chasing some of the scarcely traded commodities (especially in agricultural commodities) can drive up of prices – a key point of political contention. We believe, selective regulatory intervention in the form of increased margin requirements/trading ban etc as done in case of agricultural commodities as opposed to complete absence of these players from commodity derivatives trading can lead to higher participation. Moreover, commodities like precious metals, base metals, crude, natural gas, which are linked to global benchmarks, should not be materially affected by the possible negative fallout (speculation) of institutional participation.

Key areas addressed in Forward Contracts (Regulations) Amendment Bill (FCRA), 2010

- ✧ To give statutory powers to FMC and making it autonomous institution similar to SEBI giving it powers to impose penalties
- ✧ Allowance of options as commodity derivatives instrument.
- ✧ Give direction to set up a separate clearing corporation for a commodity exchange.
- ✧ Extend the maximum delivery period in ready delivery contract from current 11 days to 30 days

Source: *pib.nic.in, prsindia.org, India Infoline Research*

MCX well poised to capture these opportunities

In anticipation of capturing these opportunities, MCX has proactively invested in terms of designing new products, global strategic alliances and technology platforms. For instance, to capitalize on the allowance of options as a derivative instrument, MCX in FY09, had already obtained the requisite options technology platform from its parent FTIL. Besides, it has invested significant efforts in design/innovation for newer products like indices (viz. MCXCOMDEX, MCXAgri, MCXMetal etc), weather/freight futures and strategic tie-ups with global entities like Baltic Exchange (to provide market price indices for freight derivatives).

MCX has pro-actively invested in new products/technology/alliances to capitalize on anticipated regulatory changes

Financial Analysis

Revenue growth a function of trading turnover

MCX's industry leading turnover, its resultant market depth in the key commodities (i.e. the higher liquidity) and the broad-based product portfolio has resulted in strong growth as well as stickiness of its membership base. MCX derives majority of its revenues from the commission charged to members for trading on its exchange platform. These are driven by the total value of all contracts traded on the exchange i.e. the turnover and also the transaction fees charged per unit of turnover.

96% of the revenues currently are driven by total turnover on the exchange

Correction in average realized commissions over FY07-12

The spectacular growth in trading turnover as described before (47% CAGR over FY07-12) has led to a relatively slower growth in the transaction fees revenues (96% of the total operating revenues) on the back of correction in realized commission rates over the same period. In order to improve market share in the face of growing competition as well as encouraging higher turnover, MCX changed its transaction fee structure in Q3 FY10. As a result there was shift in the turnover from its top clients towards higher turnover (lower fees) slab which consequently impacted the realization. Interestingly, despite much lower fee structure at some of its peers, MCX has continued to expand its market share till date.

Change in transaction fee structure and migration of top clients to high turnover (lower fees) slab has resulted in effective realizations to correct

FY12 revenue mix for MCX

Revenue stream	% contribution
Transaction fees	96.0
Membership fees	1.1
Annual subscription	2.5
Terminal charges	0.4

Source: Company, India Infoline Research

Change in fee structure at MCX

Before Nov'09		After Nov'09	
Average Daily Turnover (Rs)	Transaction fees (Rs/one lakh of turnover)	Average Daily Turnover (Rs)	Transaction fees (Rs/one lakh of turnover)
0-0.2bn	4	0-2.5bn	2.5
0.2-1bn	3	2.5bn-10bn	1.25
1-3bn	2	>10bn	1
>3bn	1		

Source: Company, India Infoline Research

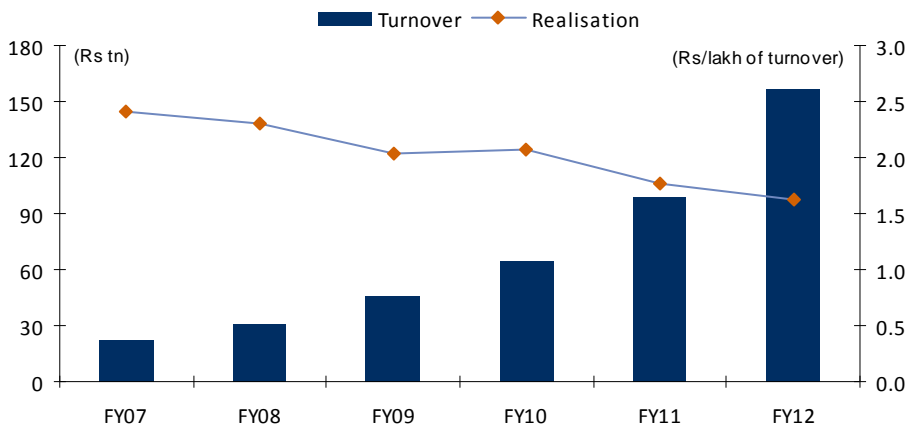
Despite lower fee structure by rival exchanges, MCX has been able to maintain market share due to its strong liquidity and robust technology platform

Current fee structure at various national commodity exchanges (India)

NMCE		NCDEX		ICEX	ACE
Avg. Daily turnover (Rs)	Transaction fees (Rs/one lakh of turnover)	Avg. Daily turnover (Rs)	Transaction fees (Rs/one lakh of turnover)		
0-0.2bn	4	0-2.5bn	2.5	Flat 1Rs /one of turnover	Flat 1Rs /one of turnover
0.2-1bn	3	>2.5bn	0.65		
1-2bn	2				
>2bn	1				

Source: Company, NCDEX, NMCE, ICEX, ACE websites, India Infoline Research

Turnover remained strong on the back of reduced transaction fees



Source: Company, India Infoline Research

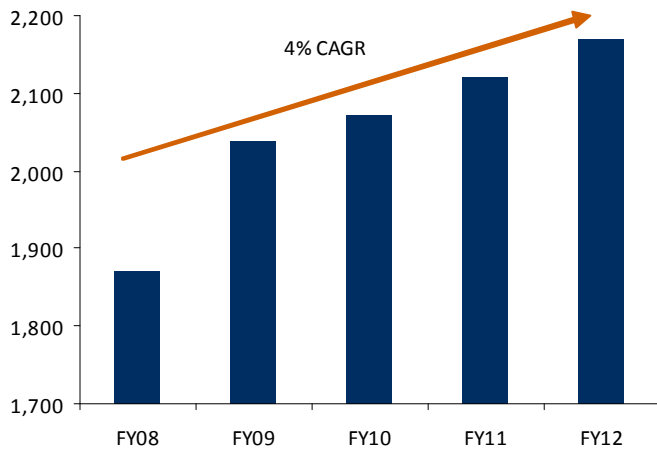
Membership base stabilizing; terminal growth continues to be strong

Other smaller revenue streams for MCX include the annual subscription fees, membership fees and terminal charges paid by its members. Post strong additions of trading members since inception and non-allowance of participants other than retail and corporate (as yet), the membership base is now stabilizing. On the other hand, the terminal growth has shown robust growth in the past five years (barring FY10). Though the strong terminal growth may not lead to higher terminal fees (as most of the members switch to other vendors like FTIL/Omnisys for market access), the growth is a qualitative lead indicator of the futures volumes on the exchange.

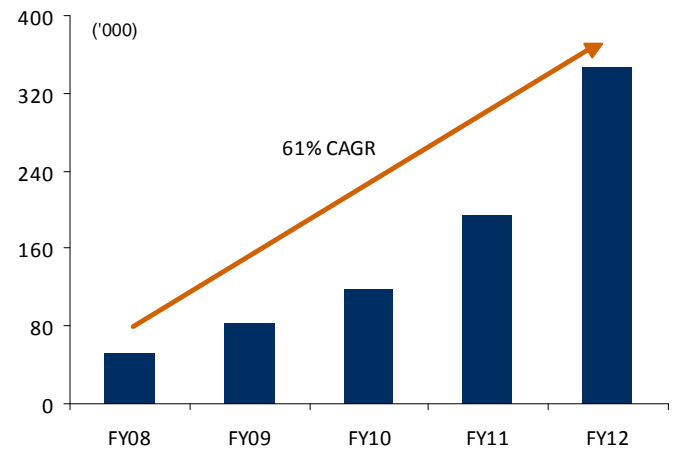
Due to restricted participation, MCX membership base has largely stabilized.

Terminal growth – a qualitative lead indicator of future turnover from members remains strong

Members grew at 4% CAGR over FY08-12



Terminals grew at 61% CAGR over FY08-12



Source: Company, India Infoline Research

Lack of volatility, saturated base may slow down volumes in near term

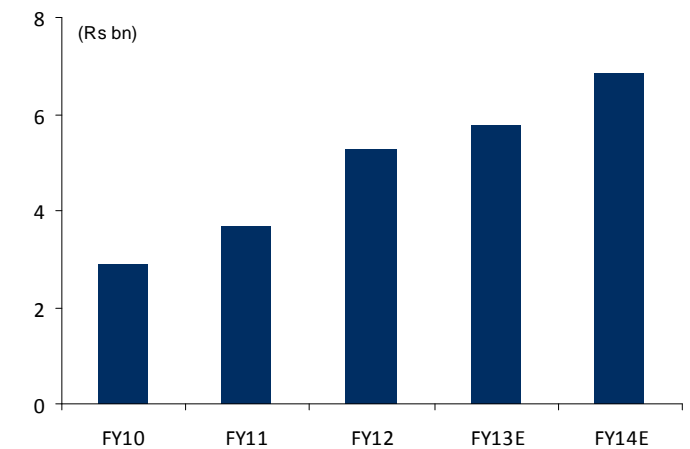
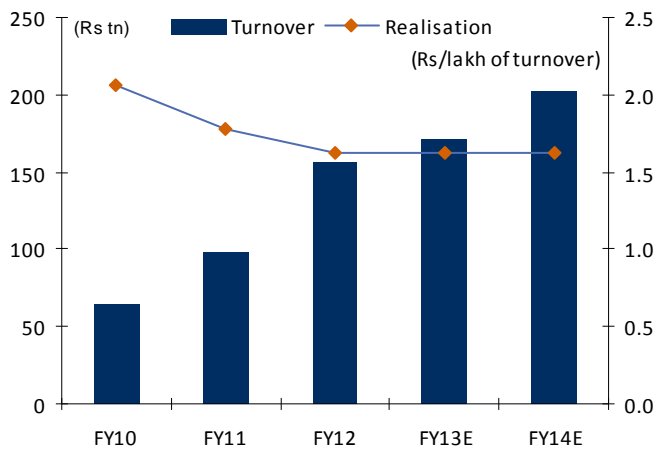
Strong price run-ups/volatility in the top four commodities especially precious metals like Gold /Silver due to their safe haven nature, higher industry demand (for silver/base metals) and also for crude oil due to global macro uncertainty led to robust volumes in past two years at MCX. For instance, turnover growth in FY12 (+60% yoy) was the highest in the last five years. Volatility of these key commodities has been dwindling in the recent past on possible lack of macro trigger as well as lower demand for base metals due to subdued global growth expectation. Record prices in gold/silver (more so due to strong rupee depreciation) have also impacted the turnover of these commodities. Additionally, with the restricted membership base (non-allowance of institutions for commodity trading), regulatory delay on introduction of newer products like indices/weather/freight futures, further market expansion remains limited. On a positive note, the low historical correlation among the key commodities (except gold-silver pair) tends to balance the correction in volumes in one commodity with the growth in another. Considering these factors as well as the strong growth (high base) in FY12, we factor in a conservative 14% turnover CAGR over FY12-14E to factor in the near term consolidation in the commodity market turnover. On the realization front, due to strong churn of members towards higher volume (lower fee) slab, we anticipate flat realizations over FY12-14E

Lack of volatility, rupee movements offsetting global prices volatility, saturated member base as well as high base of FY12 has resulted in slowing down in near term volumes

Conservatively estimate 14% rupee turnover over FY12-14E

Turnover to grow at 14% CAGR; Realisations to remain flat over FY12-14E

Revenues to growth at 14% CAGR over FY12-14E



Source: Company, India Infoline Research

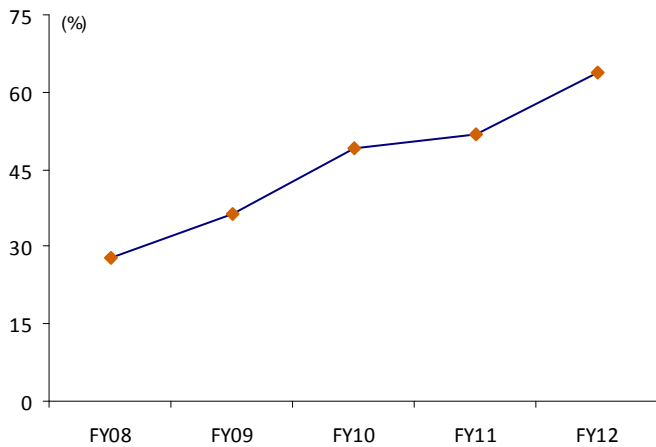
OPM more than doubled over FY08-12 on the back of operating leverage

The key positive of an exchange business is the ability to leverage on a fixed asset base to support increasing turnover. As the volumes ramp up, operating leverage effectively helps expand its profitability substantially. This is evident in the strong profitability profile of various matured exchanges in developed markets. (40-65% EBITDA margin). MCX, similarly, has experienced strong expansion in its profitability resulting in its OPM more than doubling over FY08-12

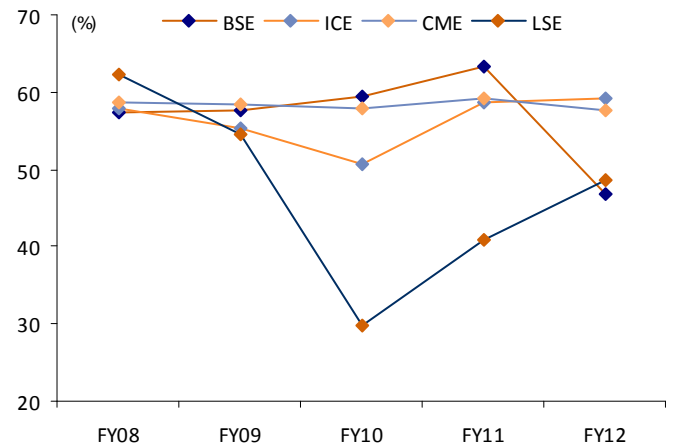
Due to a largely fixed cost base and expanding volumes, operating leverage has helped the OPM to double over FY08-12

Globally exchanges have a strong profitability profile due to similar operating leverage

Strong OPM expansion on the back of operating leverage



Sustained OPM performance across exchanges globally



Source: Company, India Infoline Research

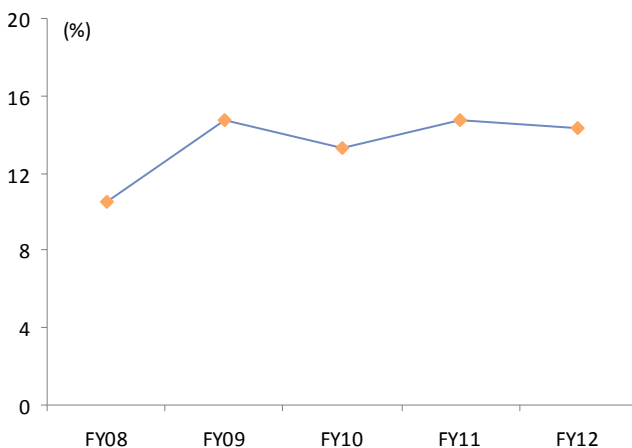
Lower up-front technology investment as against to other exchanges

Another important factor significantly impacting the profitability for an exchange is the technology cost which is largely front-ended requiring large capital outlay initially and hence lengthening the breakeven period. For MCX, it benefited from the lower up-front investment needed for set-up of its technology platform due to the strong backing from its promoter FTIL-one of the market leaders in exchange related software. For instance, MCX since inception has spent only US\$40mn on technology including initial capital expenditure of ~US\$5mn. On the other hand, exchange groups like ICE/CME spend nearly US\$40-50mn on capital investment as well as operational expenditures annually towards technology for their respective exchange platforms.

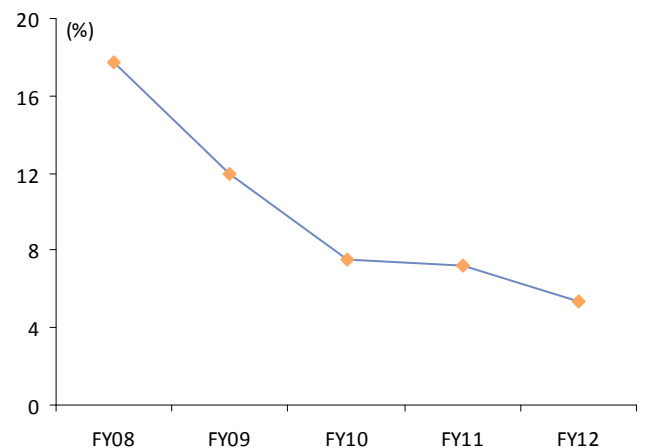
Lower up-front technology investment due to FTIL backing helped quicker break even for MCX.

Since inception, MCX has spend only US\$40mn in technology capex versus annual US\$40-50mn for exchanges like CME & ICE group

Technology costs as a % of revenues have stabilised

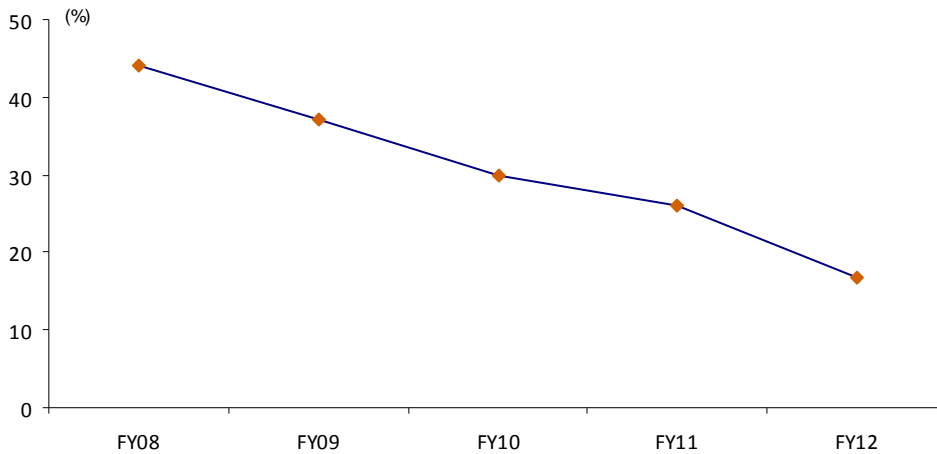


Employee costs as % of revenues have come down



Source: Company, India Infoline Research

SG&A expenses(ex-tech cost) as % of revenues have come down



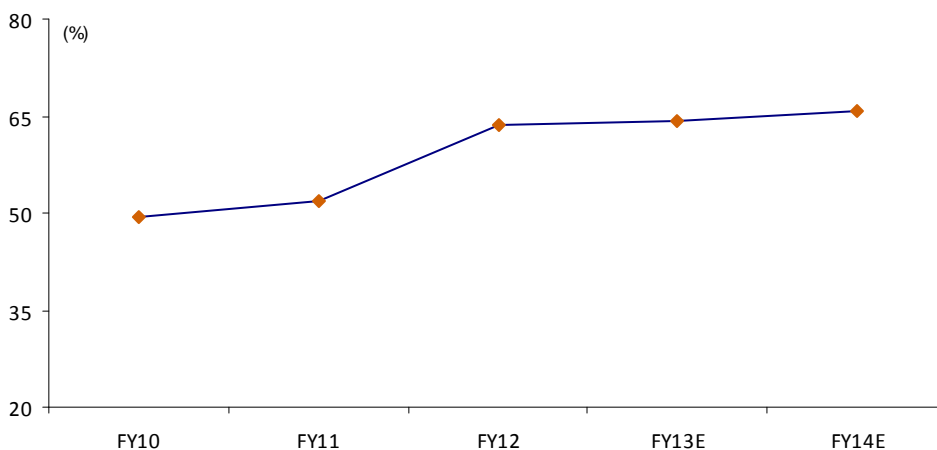
Source: Company, India Infoline Research

Operating margin to remain stable over FY12-14E

Over FY12, MCX's operating margin further expanded significantly (+11.6% yoy) on the back of employee base optimization, substantial reduction in the shared business support charges and outsourcing of variety of administrative functions. The reshuffling of employees to other ventures/exchanges of parent FTIL has resulted in the employee base correcting from 333 to 250 over last two years. Going forward a higher variable technology cost (which is paid to FTIL) could be probable headwind from the margin perspective. MCX currently pays Rs10mn per month +12.5% of transaction fees earned. We have not currently built in a material increase in the technology costs and expect it to have only an inflation-linked increase. On the back of the substantial cost optimization in recent past and lower expected operating leverage advantage (due to lower estimated turnover growth), we expect the operating margin to be largely stable over FY12-14E.

Post the strong margin expansion over last five years and limited operating leverage headroom., we expect OPM to remain stable over FY12-14E

Operating margin to remain stable over FY12-14E



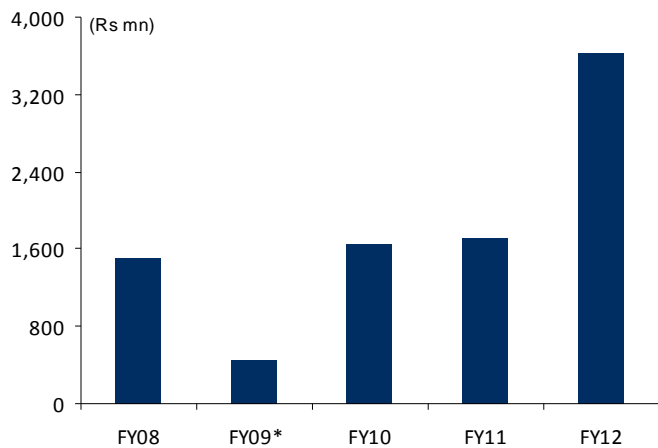
Source: Company, India Infoline Research

Lower working capital & capex needs implies stable cash flow generation

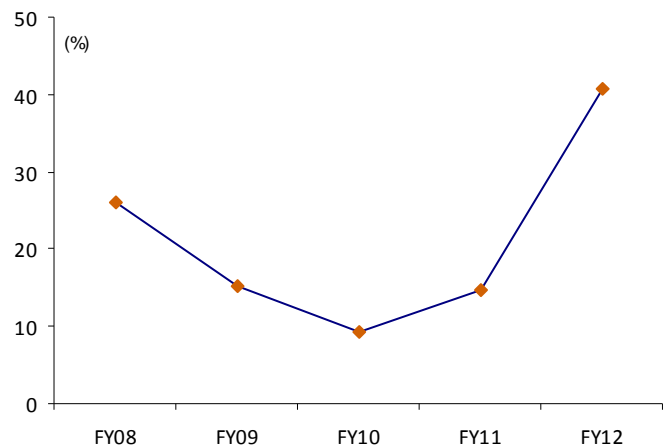
Being an exchange, the debtors and creditors for MCX are quite low as compared to other industries. Monthly accretion of transaction fees, strong credit risk management system (hence significantly lower defaults) and daily trade settlement are the key reasons for lower working capital needs. Lower upfront technology capital expenditure due to its association with FTIL has also helped MCX turn cash flow positive sooner than peers. Also, in anticipation of regulatory approvals, MCX has proactively investment in options in commodity derivatives and designing of newer products like freight, weather and indices futures and hence no material capital expenditure is expected in near term. From capacity perspective too, the exchange platform’s current capacity of 10mn transactions per day is only marginally utilized with the highest daily turnover being only 1.8mn transactions till date. Considering these factors, we believe, cash flows should remain healthy and hence expect steady dividend payout going forward. In FY12, itself, the company paid 40%+ of its profits as dividends.

Lower working capital requirement for an exchange and largely completed capital investments should result in consistent cash flow generation

Free cash flows (excluding trading margins) have improved



Improving dividend payout



Source: Company, India Infoline Research

* FY09 had an proactive investment in options technology

Valuations

Market leader with strong growth/profitability & stable cash generation

MCX growth towards becoming India's foremost commodity derivatives exchange in the last nine years has undoubtedly been commendable. Its prudent product design/innovation, broad-based product portfolio and FTIL sourced technology are helping it to ride the secular growth wave in Indian commodity derivatives market. Despite increased competition and resultant pricing pressures, MCX has registered a strong 30%+ revenue growth CAGR over last four years. RoE too has remained robust at 25%+ on the back strong operating margin profile as well as its zero debt. With most of the capital expenditure for near-medium term being done with and lower working capital requirement, cash flow generation too should be stable. Going forward, continued growth of Indian economy, introduction of newer product categories, possible allowance of options as a derivative instrument and institutional participation in commodity derivatives should lead to sustainable market growth. These and MCX's established market depth in its key commodities, highly scalable technology platform, various global alliances and strong presence across the commodity supply chain should help it maintain its market leadership hence justifying premium valuations. Additionally, its 37% economic interest in MCX SX, which has recently received permission to facilitate trading in Equity, F&O, wholesale debt market amongst others, can provide additional upside to our estimates.

Strong growth profile(47% turnover CAGR over FY07-12) , robust RoEs (25%+), dominant market share, strong technology backing and sticky liquidity demand premium valuations

Gains from MCX-SX stake sales over next 3 years can add further upside to our estimates

An analysis of the P/E valuations for the leading exchanges globally shows that the exchanges in emerging markets trade at material premium to their developed market counterparts due to higher growth prospects in emerging markets and their improving profitability profile (due to operating leverage). Resultantly, we assign a 20x P/E multiple to FY14E earnings and arrive at a 9-month TP of Rs1510.

Emerging market exchanges trade at premium to developed market counterparts

Valuations of various exchanges globally

Exchange	One year fwd P/E
CME Group	15x
NYSE Euronext	9.7x
ICE group	15.6x
CBOE	15.2x
Australian Stock Ex.	14.1x
Nasdaq OMX	8x
Developed market Avg.	13x
Hong Kong Ex. & Clearing	22x
Singapore stock Ex.	23x
Osaka securities Ex.	11x
Asian Markets Avg.	19x

Source: Bloomberg, India Infoline Research

Key Risks

- ✧ **Asset concentration risk** -MCX business is solely related to the derivatives trading of single asset class i.e. commodities and hence subject to possible concentration risk with no other asset class to offset the same. Exchanges facilitating trading of more asset classes have relatively higher stability of turnover and subsequently earnings. For example, at CME, trading is facilitated in various asset classes like interest rates, equities, foreign exchange, energy and other commodities like metal and agricultural products and hence provides diversification benefits.
- ✧ **Regulatory intervention and its impact on commodity trading** - Most of the regulatory intervention on commodity derivative trading has been for agricultural commodities where speculation can lead to inflated prices. While agricultural commodities trading on MCX is minuscule, an intervention in other commodities (non-Agricultural) can have an impact on the turnover growth of the company.
- ✧ **In-house clearing of trades versus a separate clearing house** - Though a separate entity – MCX CCL has been instituted for clearing and settlement of trades but due to lack of regulatory clearance, it has been non-operational. All the trades on the MCX exchange platform are settled in-house. While there is a comprehensive risk management system, risk of any credit default is borne currently by MCX Ltd.
- ✧ **Investments in anticipation of newer products are subject to regulatory clearance** - In anticipation of favourable regulatory ruling, MCX has proactively made investment in technology/product design of options, newer products like weather/freight indices etc. In the absence of the anticipated regulatory clearance, these investments would have to be written off.
- ✧ **Lack of clarity in treatment of investment income on client's margin money** - While the write off of Investor Protection fund (IPF) contingent liability in FY12 is completed, clarity with respect to treatment of investment income from members' trading margin is still to crystallise. MCX currently treats this income as a part of its other income and awaits a directive from the regulator regarding the same.

Company background

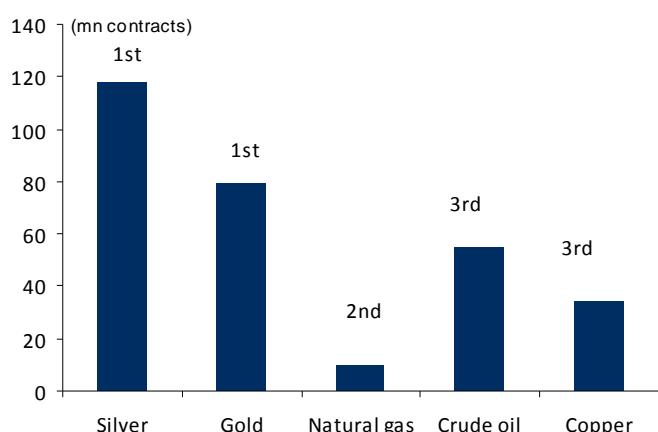
Multi Commodity Exchange of India Ltd (MCX) is an independent state-of-the-art electronic commodity exchange based in Mumbai, India. This demutualised Exchange has permanent recognition from the Government of India to facilitate online trading and clearing & settlement operations for commodity futures across the country. MCX enjoys highest market share amongst 21 commodity exchanges in India (including five national commodity exchanges—MCX, NCDEX, NMCE, ICEX, and ACE). The market share (in terms of the value of commodities traded) at the end of FY12 increased to 86% as compared to 82% in FY11. MCX also distinguishes itself as third largest commodity exchange in the world in terms of contracts traded in CY11. On the MCX, more than 47 commodities across various segments such as bullion, ferrous and non-ferrous metals, energy, and a number of agri-commodities are traded. As of Dec 2011, the exchange stands apart as being world's largest exchange in silver and gold, second largest in natural gas and the third largest in crude oil with respect to the number of futures contracts traded.

MCX is one the five national commodity derivatives exchanges with operations starting in FY04

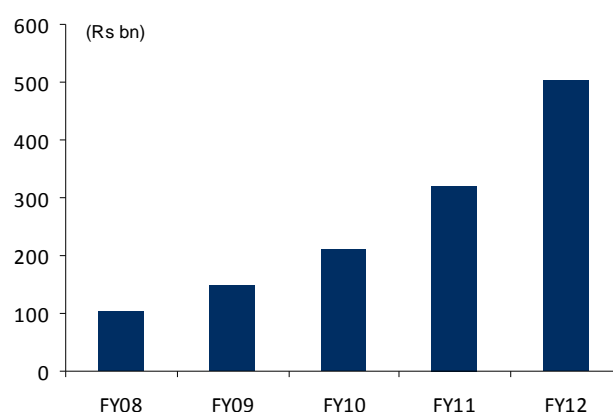
MCX focuses on precious metals, base metals and energy baskets

Market share for FY12 stands at 86%

MCX's global ranks in its key commodities (no. of contracts traded) for CY11



Average daily volumes trending upwards



Source: Company, India Infoline Research

Top 5 global commodity exchanges and their volumes in over CY10-11

Rank	Exchange	2010 (in mn)	2011 (in mn)
1	CME Group(includes CBOT and Nymex)	3,081	3,387
2	CBOE Group(includes CFE and C2)	1,124	1,217
3	MCX (includes MCX-SX)	1,082	1,196
4	Zhengzhou Commodity Exchange	496	406
5	Intercontinental exchange	329	381

Source: FIA, India Infoline Research

MCX stands third among commodity exchanges globally in terms of number of contracts traded

Technology – a distinguishing factor

The core of MCX operations- the electronic trading platform is supplied by its promoter, FTIL - leading technology company in exchange-related software. The Exchange's online trading platform is accessible to its members through trader workstation or computer-to-computer link ("CTCL") using multiple connectivity media including VSATs, VPN, leased lines, and the internet. The technical expertise and experience of FTIL provides MCX with a competitive advantage which enables it to obtain speedy and efficient technology solutions such as customization and development of new software for newer products and services. The platform is highly scalable and hence has been able to easily accommodate the huge spurt in commodity trading in past six years. The current technology infrastructure enables the exchange to handle trading volumes of up to 10mn trades a day which as yet have reached a high of only 1.867mn trades in a day.

FTIL, MCX's parent provides all essential technology platform and the related infrastructure

Ecosystem enhanced by key domestic and international strategic alliances

MCX has entered into strategic alliances with various national and international trade bodies which enables it to expand their business and widen market presence. Its association with FTIL group companies, NBHC and NSEL, enhances MCX's ecosystem by providing spot market trading, commodity warehousing and collateral management services for the MCX's clients. Internationally, MCX has formed strategic alliances with various exchanges such as the London Metals Exchange (LME), the New York Mercantile Exchange (NYSE), Shanghai Futures Exchange and Taiwan Futures Exchange among others to penetrate newer markets, enhance product offerings, increase market presence and identifying new avenues for growth.

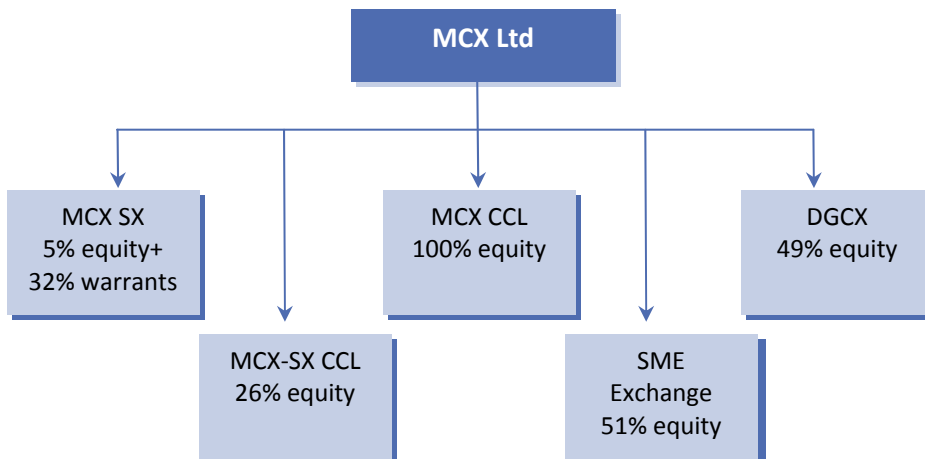
Various alliances help to expand business and increase market penetration

Key companies where MCX is a stake holder:

- ❖ *MCX Stock Exchange (5% stake; 37% economic interest)* - MCX-SX is one of the largest currency derivatives exchange in the world (registered largest number of contracts globally in USD/INR currency futures contracts). MCX Ltd holds 5% equity stake and another 32% in the form of warrants in MCX-SX, posts its dilution to confirm with MIMPS regulatory norm. This was done in order to become eligible for permission to facilitate trading in other asset classes primarily equity, F&O, wholesale debt among others. Post the stake reduction and a green signal from SEBI, it has recently started operation in these new segments. MCX is further mandated to reduce its equity stake to 2.5% in next 18 months and reduce its warrants holding to nil in next three years.
- ❖ *MCX-SX Clearing Corporation Limited (26% stake)* -MCX Ltd holds 26% in this entity (incorporated in FY09) responsible for the clearing and settlement of trades on MCX-SX. MCX-SX CCL's objective is to act as a central counterparty to all the trades on MCX-SX providing full novation. The equity stake has resulted in a share of profits for MCX Ltd to the tune of Rs1.8mn in FY12.

- ❖ *Multi Commodity Exchange Clearing Corporation Limited (100% subsidiary)*
 - Incorporated in FY09, MCX CCL was established to facilitate clearing and settlement of all kinds of commodity trades and the provision of counterparty risk guarantee on MCX. Currently, due to lack of approval to operate as a clearing house, all the clearing & settlement operations are carried out by MCX Ltd and not MCX CCL. Once the current FCRA amendment bill containing provision to allow separate clearing entity is passed, MCX CCL would function in its instituted role.
- ❖ *SME Exchange of India Limited(51% subsidiary)* - Incorporated in FY11, SME Exchange was set up to enable small and medium enterprises to transact, clear and settle trades in the equity and derivatives segment.
- ❖ *Dubai Gold and Commodity Exchange (49% JV)* - A commodities and currencies exchange JV between Dubai multi-commodities center in Dubai

MCX holding in various companies



Source: Company, India Infoline Research

Strong management bandwidth

Strong top management bandwidth has been one of the key reasons for the substantial success of MCX as a commodity exchange. This has helped the company to make timely investments in products as well technology and resultantly capture the market share much early in its existence. Management's extensive experience in commodity market, we believe, should continue to bolster the company's competitive advantage and help maintain its market share going forward.

Substantial management bandwidth with deep domain expertise has helped MCX to achieve its industry leading position

Key management personnel

	Designation	Experience
Mr. Venkat Chary	Non-Executive Chairman	-Ex Chairman ,FMC -Retired IAS official
Mr. Shreekant Javalgekar	MD and CEO	- Formerly, Director – Finance, Investor Relations & Communications, FTIL -Worked as India Advisor to NexGen Fin. Sol., Singapore -Former MD, Lazard India
Mr. Parveen Kumar Singhal	Deputy Managing Director	-Former Division Chief – SEBI -Former Executive Director – Delhi Stock Exchange LTD. -Former Director – FMC -35 Years of Executive cadre experience
Mr. Dipak D. Shah	Director - Market Operations	-Ex-MD and Ex- CEO of OTCEI LTD. -25 Years of Professional Experience
Mr. Sumesh Parasrampur	Director - Business Development	-14 Years of Experience in Commodities Trading and Risk Management
Mr. P. Ramanathan	Company Secretary & Chief Compliance Officer	-Ex- VP and CS, FTIL -24 Years of experience in the field of legal and secretarial practice
Mr. Mahesh Joshi	Chief Financial Officer	-Ex- CEO , FTIL -18 years of experience in the field of finance
Mr. PP. Kaladharan	Chief Technology Officer	-Worked with BSE for over 15 years
Mr. Suman Das Sarma	Senior Vice President – Communications	Worked with various Media houses -20 Years of experience in Brand Management and Communications
Mr. J. B. Ram	Senior Vice President - Membership & Inspection	- 25 years of experience including CDSL, Unit Trust of India & SEBI
Mr. Raghavendra Prasad	Vice President – Legal	-Ex-deputy legal officer at SEBI -19 years of experience in the field of legal practice

Source: Company

Financials

Income statement

Y/e 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Revenue	3,689	5,262	5,791	6,833
Operating profit	1,918	3,347	3,717	4,503
Depreciation	(247)	(272)	(330)	(350)
Other income	787	1,031	1,114	1,169
Profit before tax	2,457	4,105	4,501	5,321
Taxes	(727)	(1,098)	(1,260)	(1,490)
Minorities and other	3	1	1	1
Adj. Profit	1,734	3,009	3,242	3,833
Exceptional items	-	(142)	-	-
Net profit	1,734	2,867	3,242	3,833

Balance sheet

Y/e 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Equity capital	510	510	510	510
Reserves	7,951	9,468	11,193	13,232
Net worth	8,461	9,978	11,703	13,742
Deferred tax liab (net)	127	151	151	151
Total liabilities	8,588	10,129	11,854	13,893
Fixed assets	1,953	1,877	1,747	1,597
Investments	8,237	11,511	12,454	13,421
Net working capital	(1,603)	(3,259)	(2,347)	(1,125)
Sundry debtors	489	514	555	655
Cash	3,312	3,125	3,538	5,820
Other current assets	1,010	1,742	1,917	2,262
Sundry creditors	(6,045)	(7,069)	(7,780)	(9,181)
Other current liabilities	(368)	(1,570)	(578)	(682)
Total assets	8,588	10,129	11,854	13,893

Cash flow statement

Y/e 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Profit before tax	2,457	3,963	4,501	5,321
Depreciation	247	272	330	350
Tax paid	(727)	(1,098)	(1,260)	(1,490)
Working capital Δ	1,192	1,469	(498)	1,059
Other operating items	3	1	1	1
Operating cashflow	3,172	4,608	3,074	5,242
Capital expenditure	(272)	(195)	(200)	(200)
Free cash flow	2,900	4,412	2,874	5,042
Equity raised	54	82	-	-
Investments	(2,067)	(3,274)	(943)	(967)
Dividends paid	(296)	(1,432)	(1,517)	(1,794)
Other items	21	24	-	-
Net Δ in cash	611	(188)	414	2,282

Key ratios

Y/e 31 Mar	FY11	FY12	FY13E	FY14E
Growth matrix (%)				
Revenue growth	28.4	42.6	10.1	18.0
Op profit growth	35.5	74.5	11.1	21.1
EBIT growth	(23.9)	67.0	9.6	18.2
Net profit growth	(21.5)	73.6	7.8	18.2
Profitability ratios (%)				
OPM	52.0	63.6	64.2	65.9
EBIT margin	66.6	78.0	77.7	77.9
Net profit margin	47.0	57.2	56.0	56.1
RoCE	31.4	43.9	41.0	41.3
RoNW	22.5	32.6	29.9	30.1
RoA	12.7	17.8	16.6	17.4
Per share ratios				
EPS	34.0	56.2	63.6	75.2
Dividend per share	5.0	24.0	25.4	30.1
Cash EPS	38.8	64.3	70.1	82.0
Book value per share	165.9	195.7	229.5	269.5
Valuation ratios				
P/E	38.8	23.4	20.7	17.5
P/B	7.9	6.7	5.7	4.9
EV/EBIDTA	33.3	19.1	17.1	13.6
Payout (%)				
Dividend payout	14.7	40.7	40.0	40.0
Tax payout	29.6	26.7	28.0	28.0
Liquidity ratios				
Debtor days	48	36	36	36

Du-Pont Analysis

Y/e 31 Mar	FY11	FY12	FY13E	FY14E
Tax burden (x)	0.71	0.73	0.72	0.72
Interest burden (x)	1.00	1.00	1.00	1.00
EBIT margin (x)	0.67	0.78	0.78	0.78
Asset turnover (x)	0.27	0.31	0.30	0.31
Financial leverage (x)	1.77	1.83	1.80	1.73
RoE (%)	22.5	32.6	29.9	30.1

In the year 2011 itself, we have received two reputed awards for being the Best Broker in India.

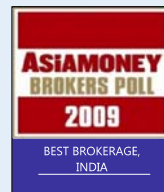
'Best Equity Broker of the Year' – Bloomberg UTV, 2011

IIFL was awarded the 'Best Equity Broker of the Year' at the recently held Bloomberg UTV Financial Leadership Award, 2011. The award presented by the Hon'ble Finance Minister of India, Shri Pranab Mukherjee. The Bloomberg UTV Financial Leadership Awards acknowledge the extraordinary contribution of India's financial leaders and visionaries from January 2010 to January 2011.

'Best Broker in India' – Finance Asia, 2011

IIFL has been awarded the 'Best Broker in India' by Finance Asia. The award is the result of Finance Asia's annual quest for the best financial services firms across Asia, which culminated in the Country Awards 2011.

Other awards



Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

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IIFL, IIFL Centre, Kamala City, Senapati Bapat Marg, Lower Parel (W), Mumbai 400 013.

For Research related queries, write to: Amar Ambani, Head of Research at amar@indiainfoline.com or research@indiainfoline.com

For Sales and Account related information, write to customer care: info@5pmail.com or call on 91-22 4007 1000