MOTILAL OSWAL

the CornerOffice
Interaction with the CEO

Reform ball set rolling…

…multiple other opportunities in the pipeline post options introduction

We met with Mr Mrugank Paranjape, CEO of MCX, to discuss (i) recent and upcoming regulatory changes that would mark the introduction of new products, participants and opportunities for exchanges and (ii) MCX's strategy and positioning to capitalize on these opportunities. Key takeaways:

Multiple avenues for growth

- Opportunity for MCX would come from [1] introduction of derivative products, [2] market opening up to new participants and [3] asset classes opening up to all exchanges.
- The Securities and Exchange Board of India (SEBI) has been following the above order in its regulatory reforms, with the most recent one being allowing of options and releasing the guidelines with respect to the product design and risk management framework in its circular dated 13 June 2017.

A step closer to the launch of options

- Now that the guidelines have been laid out, MCX cited that options can be expected to start trading from August 2017.
- Options would be permitted on those commodities that are among the top five futures contracts in terms of total trading turnover value over the previous 12 months, and their ADT would need to be at least INR2b for agricultural commodities and INR10b for others. Initially, on a pilot basis, each exchange shall be allowed to launch options only on one commodity post the approval of the SEBI.
- MCX currently has nine commodities that meet the minimum ADT requirement. With the passage of time, it will apply for more approvals for the commencement of options trading.
- The only area that now needs more clarity is the taxation on options. The Central Board of Direct Taxes (CBDT) is expected to notify on this point soon since the SEBI circular for implementation has already seen the light of the day.

Market opening up to new participants

- SEBI-governed entities (e.g. mutual funds) are expected to be allowed to trade commodities first; others (e.g. foreign investors) should gradually follow suit.
- While timelines are currently unclear, the approval for mutual funds seems to be the nearest, given the recent progress in discussions between the AMFI and the SEBI. Approval for FPIs and banks, however, may be further away.
- Discussions between MCX and mutual funds have been boosting confidence around a pick-up in volumes, given the potential diversification that commodities offer.

Asset classes opening up for all exchanges

- Regulation gradually allowing operability for exchanges across asset classes and removing exclusivity is likely to lead to opportunities for MCX. Although MCX does not see opportunity in equities as there already are three players in the market, it could potentially capitalize opportunities in currencies.

MCX

Mr Mrugank Paranjape
CEO & Managing Director

Mr Mrugank Paranjape has over 25 years of experience in Corporate Banking, Securities Markets, Technology, Asset Management and Custodial Services.

Prior to joining MCX, Mr Paranjape was the Managing Director of Deutsche Bank A.G. During the last decade, he has held several leadership positions and assignments with Deutsche Bank in India and abroad, including Managing Director-Corporate Banking & Securities; Managing Director, Trust and Securities Services & Cash Management for FIs Asia-Pacific; Head Investor Services (IS) Asia (Singapore); Head IS, South, and South-East Asia, and India.

He has also held senior management roles in international organizations, including Prudential ICICI AMC, Reliance Logistics, IndiaInfoline.com, W.I. Carr Securities, ING Baring Securities, IIT Invest Trust and Citibank.

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- At the same time, this also opens up the market for other exchanges to enter commodities. However, MCX has clear dominance in commodities with a market share of ~85%.

Competitive intensity likely to increase

- With the likelihood of a unified license, competitive intensity is likely to inch up. Competitive forces can tighten because of [1] predatory pricing, [2] superior technology and [3] margin fungibility.
- Only 25% of the total transaction cost borne by a participant is directed to an exchange as part of fees, while the rest is constituted of taxes and regulatory costs. Thus, the room for pricing discounts in commodities is limited for exchanges to compete on.
- On the technology front, systems used by MCX are comparable to global and domestic peers, making it a level-playing field.
- Movability of margins between asset classes could give other exchanges an edge. However, even with the same license required for both equities and currencies, margin requirements are currently distinct. Whether this will change on the introduction of unified licenses remains unclear, though.

Technology landscape

- The core trading engine for MCX is provided by Financial Technologies (FT), and there is a two-way binding agreement between both the parties for the next six years. The software is very robust and not seen any glitches in the past.
- FT is among the dominant players in the technology market for exchanges, and MCX sees its technological capabilities as benchmarked to peers.

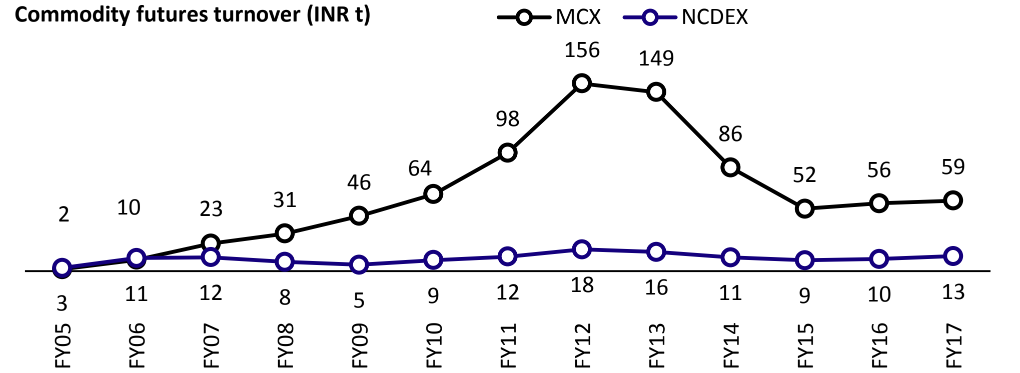
Financial expectations

- The cost base for MCX is largely stable. In FY17, it incurred several costs as it made senior leadership additions, introduced variable pay components for senior management and increased hiring in technology/risk management.
- Going forward, it sees an opportunity for operational leverage to kick in as revenue growth gets boosted by the increased number of products and participation.
- Potential for saving costs exist in [1] moving in-house some technology components that are currently being managed by FT and [2] automating multiple processes that currently need manual intervention.
- With automation initiatives kicking in, MCX does not expect significant addition to its current employee base of ~400 people. It would redeploy its resources across the organization as automation-related benefits start to seep in.

Others

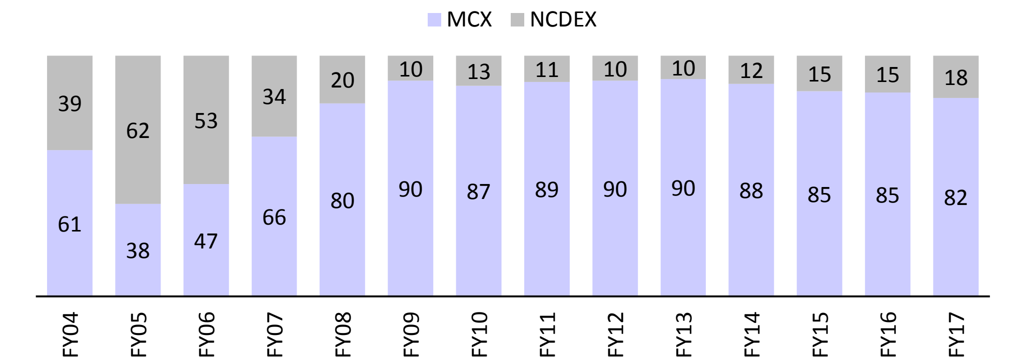
- **Volumes revival:** Post demonetization, volumes failed to pick-up in gold as inventory levels remained low. However, volumes are expected to start resurrecting post the 1 July GST implementation.
- **New products:** The company has got approval for a few new products, and has 4-5 others in the pipeline. These products would additionally contribute to volumes when they are launched.

Exhibit 1: Commodity futures turnover



Source: MOSL

Exhibit 2: Commodity futures market share (%)



Source: MOSL

Valuation view

- **Market leadership in a winner-takes-all business:** MCX has retained its market leadership position with a share of 80-90% over FY09-16. Even in the most turbulent of months during FY13-14, when the parent's existence was in deep waters on issues of fraud around National Spot Exchange (NSEL), the exchange managed to retain its share. Additionally, it has remained without a full-time MD & CEO since May 2014, when Mr Manoj Vaish resigned after just three months. This is a reflection of the winner-takes-all nature of the business model.
- **Monopoly share in multiple commodities takes care of concentration risk:** MCX's golden run in terms of volumes came at the time of significant run-up in gold and silver prices in FY12 and FY13. That was also perceived to be a risk, given that the share of volumes from these two commodities had exceeded 70%. However, presence in multiple commodities helps avert the concentration risk, and this was evidenced in FY15, when action in oil prices drove energy to exceed gold as the largest traded commodity at MCX by value.
- **All eyes on reforms as SEBI-FMC merger is complete:** The SEBI's merger with FMC is now complete, paving the way for much-awaited reforms in the ecosystem. The upside for MCX may yet be partly a function of reports around approvals to competition and entry of a credible global exchange materializing. We do not expect these at one-go or immediately, but rather in a gradual, phased manner over the course of the next calendar year. The SEBI already has the ball rolling in terms of reforms, and expects universal licenses to be active through the course of the year. MCX could in the meanwhile: [1] get a head start and [2] strengthen itself with investment from CME.

- **Volume reversal to pre-CTT levels is our base case:** Our base case assumes a gradual recovery in volumes to INR350-400b in FY19E, closer toward pre-commodities transaction tax (CTT) average daily turnover of INR450-500b. This compares with current ADT of INR200-250b.
- **Volumes have taken a temporary hit:** Volumes suffered in 2HFY17 on account of the demonetization impact on gold volumes. Post this, a failure in pick-up has resulted out of tepid activity in the physical market. This time, it is compounded by uncertainty posed by the GST. That said, MCX expects volumes to recover going forward, and options to commence in the next 2-3 months.
- **Multiplier effect on operational earnings from operating leverage, Buy:** From 2QFY18, options will also be launched, a key trigger for volumes. This should kick-start the recovery in volumes, which should continue with the entry of new participants such as FIs and new products such as indices. This drives our expectation of healthier revenue growth in FY19 (31%) and consequently driving earnings growth (~40%). Our price target of INR1,300 discounts FY19E earnings by 30x, implying 19% upside. **Buy**.

Key triggers

- Pick-up in volume led by the introduction of new products like options/indices
- Introduction of new participants like banks/FIs
- High volatility in key commodities like bullion/crude

Key risk – increased competition from equity exchanges

One of the implications of FMC's merger with the SEBI is that stock exchanges will be able to become universal exchanges, where equities, debt instruments and currencies are traded under the same roof as commodity derivatives. Stock exchanges already have depositories and clearing corporations that will cater to the needs of commodity traders as well. If the NSE enters the commodities segment, MCX could see stiff competition, which may impair both market share and profit margins.

Financials and valuations

Income Statement								(INR Million)
Y/E March	FY12	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E
Sales	**5,262**	**4,992**	**3,197**	**2,038**	**2,135**	**2,386**	**2,678**	**3,514**
Change (%)	43	(5)	(36)	(36)	5	12	12	31
Cost of Services	1,036	1,072	935	733	779	1,071	1,097	1,194
SG&A Expenses	879	987	1,014	616	804	726	799	807
EBITDA	**3,347**	**2,932**	**1,248**	**689**	**553**	**589**	**782**	**1,512**
% of Net Sales	64	59	39	34	26	25	29	43
Depreciation & Amortization	272	307	343	259	246	186	215	214
Interest	0	0	11	14	0	2	2	2
Other Income	1,027	1,427	1,202	1,285	1,191	1,373	1,512	1,618
Extraordinary items	142	-	-	-	667	-	-	-
PBT	**3,960**	**4,051**	**2,097**	**1,701**	**831**	**1,774**	**2,077**	**2,915**
Tax	1,098	1,065	569	450	413	512	519	729
Rate (%)	28	26	27	26	50	29	25	25
PAT	**2,862**	**2,986**	**1,528**	**1,251**	**418**	**1,263**	**1,558**	**2,186**
Change (%)	66	4	(49)	(18)	(67)	202	23	40

Balance Sheet								(INR Million)
Y/E March	FY12	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E
Share Capital	508	510	510	510	510	510	510	510
Reserves	9,461	11,058	10,931	11,512	11,529	13,078	13,870	14,982
Net Worth	**9,969**	**11,567**	**11,441**	**12,022**	**12,039**	**13,588**	**14,380**	**15,492**
SGF			1,720	1,871	1,879	1,705	1,705	1,705
Loan	432	569	449	343	282	420	420	420
Capital Employed	**10,401**	**12,136**	**13,610**	**14,236**	**14,201**	**15,713**	**16,505**	**17,617**
Net Block	**1,369**	**2,044**	**1,735**	**1,552**	**3,528**	**5,905**	**5,932**	**5,985**
CWIP	1	-	-	-	-	-	-	-
Other LT Assets	1,907	531	281	281	281	281	281	281
Investments	2,208	1,481	132	132	132	132	132	132
Curr. Assets	**13,274**	**13,802**	**15,267**	**16,278**	**14,227**	**12,340**	**14,693**	**15,880**
Current Investments	9,294	9,201	10,766	12,795	8,511	7,544	7,544	7,544
Debtors	514	69	90	107	42	28	81	104
Cash & Bank Balance	3,124	3,475	3,417	2,655	5,003	3,890	5,932	6,777
Loans & Advances	283	530	676	456	268	3	8	10
Other Current Assets	59	525	319	265	404	875	1,128	1,445
Current Liab. & Prov	**8,358**	**5,721**	**3,805**	**4,007**	**3,967**	**2,945**	**4,533**	**4,660**
Net Current Assets	**4,916**	**8,080**	**11,462**	**12,271**	**10,260**	**9,395**	**10,160**	**11,220**
Application of Funds	**10,401**	**12,136**	**13,610**	**14,236**	**14,201**	**15,713**	**16,505**	**17,617**

E: MOSL Estimates

Financials and valuations

Ratios								
Y/E March	**FY12**	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**	**FY18E**	**FY19E**
Basic (INR)								
EPS	**56.1**	**58.6**	**30.0**	**24.6**	**23.4**	**24.8**	**30.5**	**42.9**
Cash EPS	61.4	64.6	36.9	29.6	13.0	28.4	34.8	47.1
Book Value	195.5	226.8	225.4	235.8	236.1	266.4	282.0	303.8
DPS	24.0	0.5	10.2	10.2	-	15.3	20.4	20.4
Payout %	50.0	0.9	39.0	48.5	-	73.3	79.2	56.4
Valuation (x)								
P/E		19.2	37.5	45.8	48.2	45.3	36.8	26.2
Cash P/E		17.4	30.5	38.0	86.4	39.6	32.4	23.9
EV/EBITDA		15.4	34.6	61.2	79.8	78.5	56.5	28.7
EV/Sales		9.0	13.5	20.7	20.6	19.4	16.5	12.3
Price/Book Value		5.0	5.0	4.8	4.8	4.2	4.0	3.7
Dividend Yield (%)		0.0	1.0	1.1	-	1.6	2.1	2.1
Profitability Ratios (%)								
RoE	31.0	27.7	13.3	10.7	3.5	9.9	11.1	14.6
RoCE	24.8	26.5	12.8	10.4	8.8	9.6	10.8	14.2
RoIC	(89.8)	(151.3)	(118.5)	(35.4)	(58.6)	11.6	11.6	30.8
Turnover Ratios								
Debtors (Days)	36	5	10	19	7	4	11	11
Fixed Asset Turnover (x)	31	27	18	11	12	13	13	16

Cash Flow Statement								(INR Million)
Y/E March	**FY12**	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**	**FY18E**	**FY19E**
CF from Operations	1,600	2,470	1,949	469	512	460	671	1,213
Cash for Working Capital	1,160	(1,941)	(1,565)	503	22	(1,251)	1,277	(214)
Net Operating CF	**2,760**	**529**	**385**	**972**	**533**	**(791)**	**1,948**	**998**
Net Purchase of FA	(200)	(462)	(59)	(9)	(200)	(345)	(242)	(266)
Free Cash Flow	**2,561**	**68**	**325**	**963**	**333**	**(1,137)**	**1,706**	**732**
Net Purchase of Invest.	(2,723)	1,910	586	(1,080)	5,367	1,950	1,104	1,189
Net Cash from Invest.	**(2,923)**	**1,448**	**527**	**(1,089)**	**5,167**	**1,605**	**862**	**923**
Proc. from equity issues	-	-	-	-	-	-	-	-
Proceeds from LTB/STB	-	-	-	-	-	-	-	-
Dividend Payments	(296)	(2,134)	(1,133)	-	-	(925)	(765)	(1,074)
Cash Flow from Fin.	**(296)**	**(2,134)**	**(1,133)**	**-**	**-**	**(925)**	**(765)**	**(1,074)**
Others	273		-	-				
Net Cash Flow	**(186)**	**(156)**	**(221)**	**(117)**	**5,701**	**(112)**	**2,044**	**847**
Opening Cash Bal.	**3,310**	**3,124**	**3,475**	**3,417**	**2,655**	**5,003**	**3,890**	**5,932**
Add: Net Cash	(186)	(156)	(221)	(117)	5,701	(112)	2,044	847
Closing Cash Bal.	**3,124**	**2,968**	**3,255**	**3,300**	**8,356**	**4,891**	**5,934**	**6,779**

E: MOSL Estimates

NOTES

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