London Stock Exchange

LSE

February 11, 2016 FAT-UK-622	GBP21.50	Core	MED	B	

LSE Snapshot +

Repositioning the exchange

In times of market weakness it makes sense to dust off the files on prospective portfolio candidates. While economic and market conditions are more uncertain we have also seen valuations become more attractive. We favour looking at FTSE 100 groups and believe that the London Stock Exchange (LSE) stands out.

Shares in the London Stock Exchange (LSE) are just under 24% off the high of £27.80 reached on 29th December 2015. The company is one of the few global exchanges with London a leading financial centre.

The acquisition of Frank Russell for £1.6bn in December 2014 has increased the group's exposure to indexing and the US ETF market. It has also made the LSE less cyclical given that it is less dependent on trading volumes.

London Stock Exchange

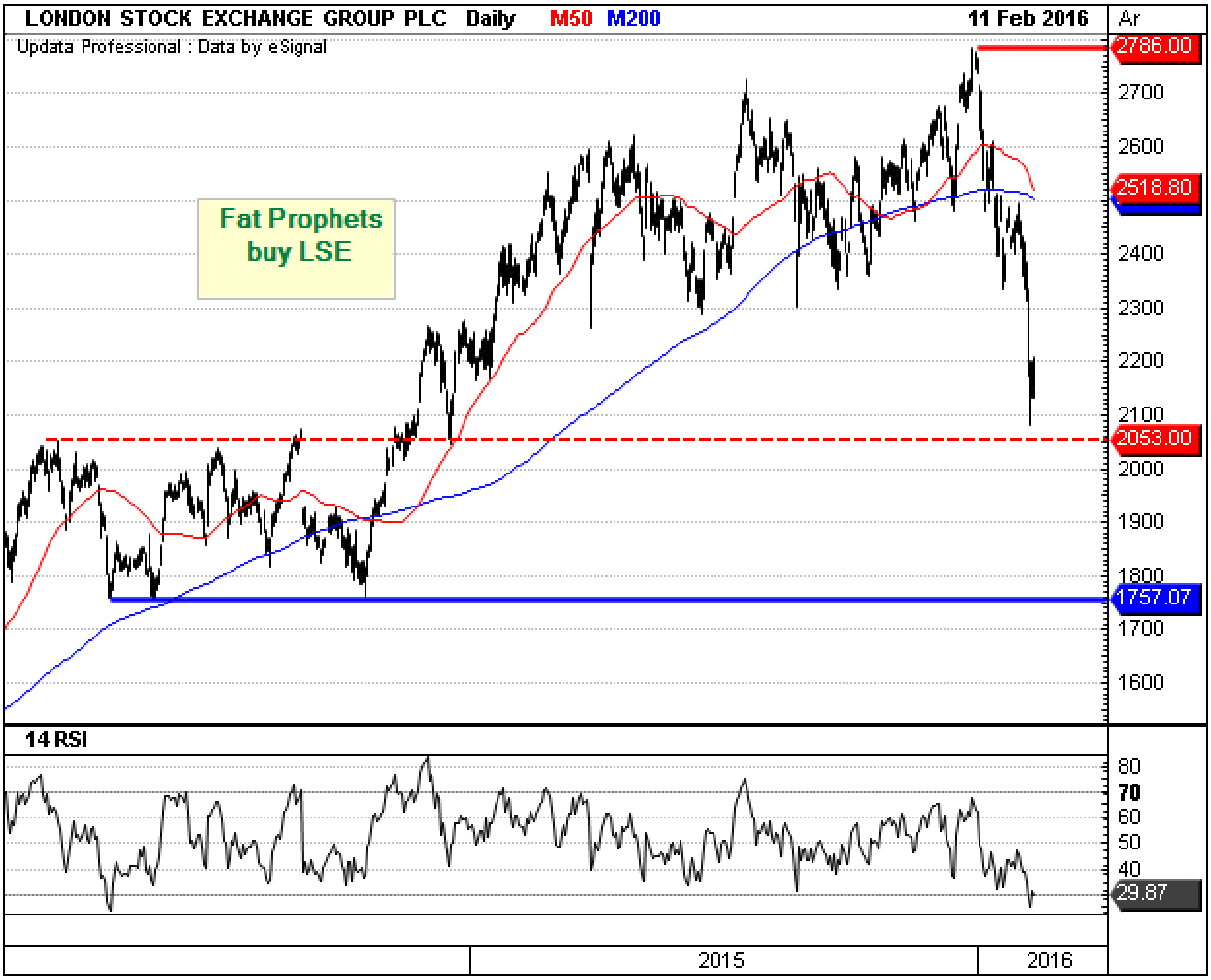
Crest & HQ at Paternoster Square

Source – Google images

London stock exchange share price since IPO

We cannot rule out, though, an impact from current market weakness on the group's trading performance. Set against this the forecast P/E has come down to 17X in 2016 and then 14.4X in 2017.

Full year results are set to be announced 4th March and will give further clarity on the dividend policy going forward. The LSE has been a long-term winner for investors and we expect this to remain the case given its recent repositioning.



Turning to the charts and the share price saw strength following a break out from a trading range in 2014. However, since hitting an all time high of 2,786p the shares have fallen below both daily averages. Prices are close to support at the 2,053p level (dating back to December 2014) and with the RSI heavily oversold it is reasonable to expect that a bounce could be imminent.

With reference to the weekly chart, the upward trend remains firmly in place. However, the recent pullback and a break below the 50-week moving average, could be indicative of interim challenges. Support exists at the 2,053p region (which previously served as resistance) should the volatility persist in the near-term.

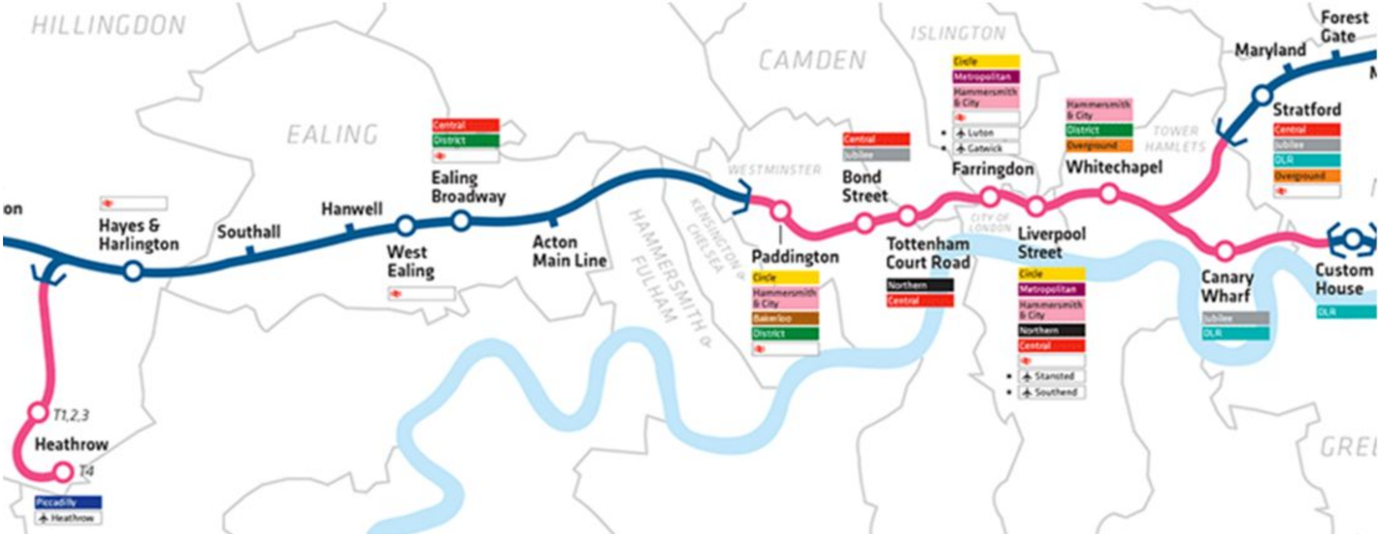
Finding the strongest portfolio candidate

For the sake of transparency it is worth reviewing why we view the LSE as the strongest portfolio candidate at this point. Recent special reports have covered real estate stocks, payment stocks and most recently compounding stocks

In the real estate sector we noted the long-term out performance of the West End REITs: Derwent London, Great Portland Street and Shaftesbury. This strength reflects strong demand and constrained supply in the West End of London.

The market sell-off has pushed all three companies to a discount to their last reported N when they had previously been at a premium. With Crossrail set to open in 2018 this is a potential opportunity to buy into this area.

Crossrail route – Set to connect the West End to Heathrow

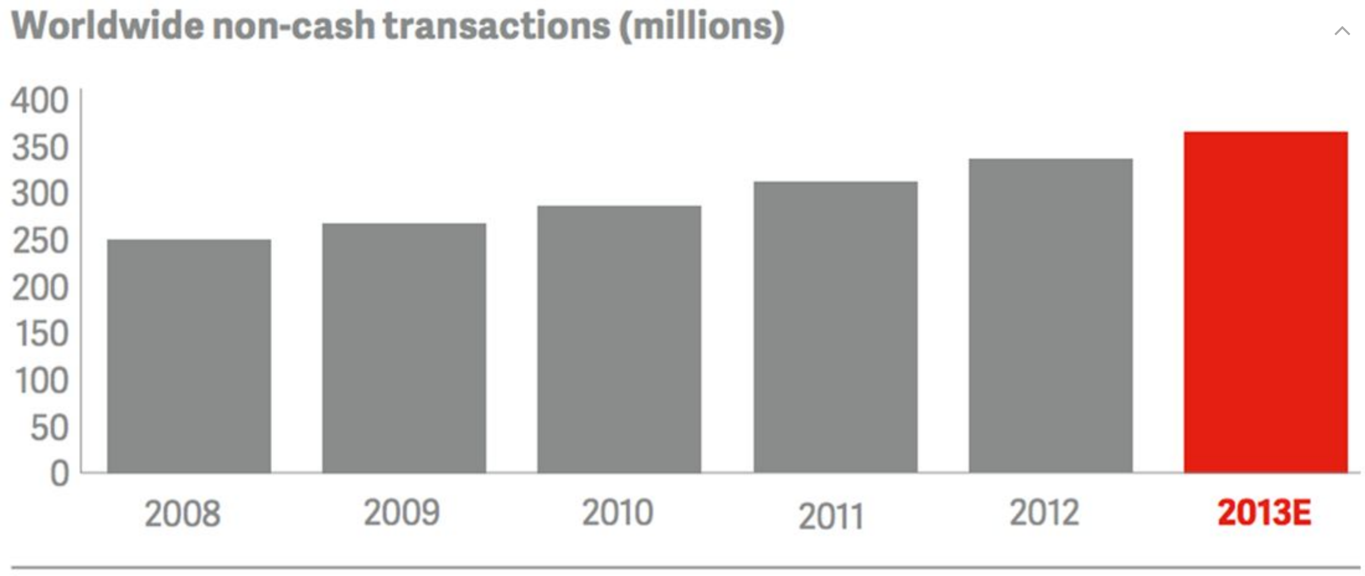


Source – Crossrail website

Other real estate portfolio candidates are CLI Holdings and Workspace Group with both at a discount to their latest NAV. Workspace is also interesting as it is focused on London and has reduced its loan to value ratio to only 17.4%.

We also recently reviewed payment companies and noted the long-term outperformance of the sector. Worldpay is the leading UK payment group while other companies are Paysafe, Safecharge and Earthport.

Payment momentum



Source: Capgemini Financial Services

Source – Worldpay annual report

In our special report this week we have looked for FTSE 100 stocks with compounding potential. The key requirement is for a company to not have "blow up risk" and to be able to earn a reasonable return on capital.

Potential compounders not in the UK portfolio include the LSE, Intercontinental Hotels (IHG), Imperial Brands, United Utilities, Intertek and Worldpay. We have decided to focus on these stocks as they are non-cyclical and also blue chips.

Imperial Brands and United Utilities are similar to stocks we already own (British American Tobacco and National Grid) and so we are ruling these out. We also have hotel exposure through PPHE Hotel Group and so are ruling out IHG.

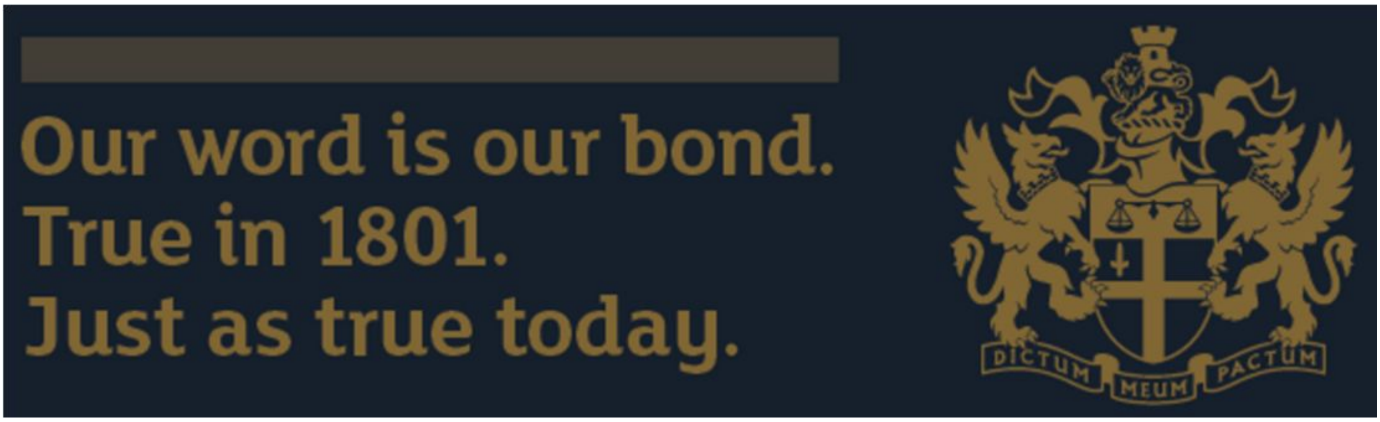
This leaves the LSE, Intertek and Worldpay as the three candidates to add to the portfolio during the current market malaise. While we already own stock exchanges (Euronext & BME) the LSE is the leading exchange in Europe.

Choosing between these three stocks is not an easy task and in reality all of them could be added to the portfolio. However, the LSE stands out for the significant change to its business mix since the takeover of Frank Russell.

The LSE also has a strong market position with leading brands like Russell and FTSE. The group also benefits from its location in London, which is one of only a few global financial centres in the world.

LSE

motto "Dictum Meum Pactum", My Word is My Bond



Source Google images

The net result is that the LSE appears to have a strong customer franchise that should withstand competition. Worldpay, by contrast, may see competition from other payment companies and Intertek competes with other testing companies.

It is worth explaining our thinking in opting for the LSE as stock origination is as important as stock analysis. If you start by looking in the strongest areas this will inevitably provide a performance tailwind.

The London Stock Exchange (LSE) in focus

Companies which have stood the test of time are generally worth looking into and the LSE has a history of over 300 years. However, times change with the 1986 "Big Bank" reforms and EU deregulation in 2007 reducing barriers to entry.

When the EU opened the market the monthly share of UK share trading fell rapidly. In January 2008 the figure had been 96% but by October 2009 it had fallen to only 58%.

The Coffee House routes of the London Stock Exchange (LSE)

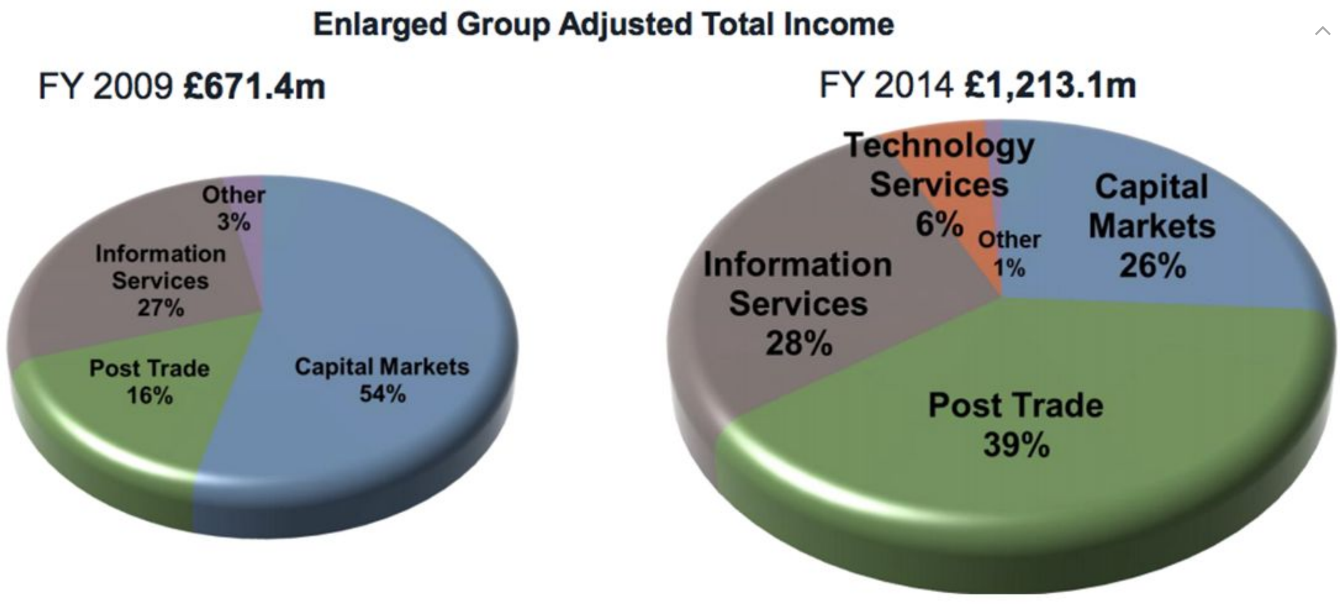
Source – Google images

The London Stock Exchange has been battling it out with BATS Chi-X Europe which was founded in 2007. In June 2014 the group retook the top position as the largest equity trading venue in Europe back from BATS Chi-X Europe.

However, the takeover of Frank Russell in December 2014 has made the LSE much more diversified. It has also reduced the exposure to volume driven business and as such as made the group less cyclical.

Even before this deal the LSE had been shifting its income generation away from capital markets. In 2019 54% adjusted income came from capital markets but in fiscal 2014 the figure fell to only 26%.

LSE is now less reliant on cyclical capital markets



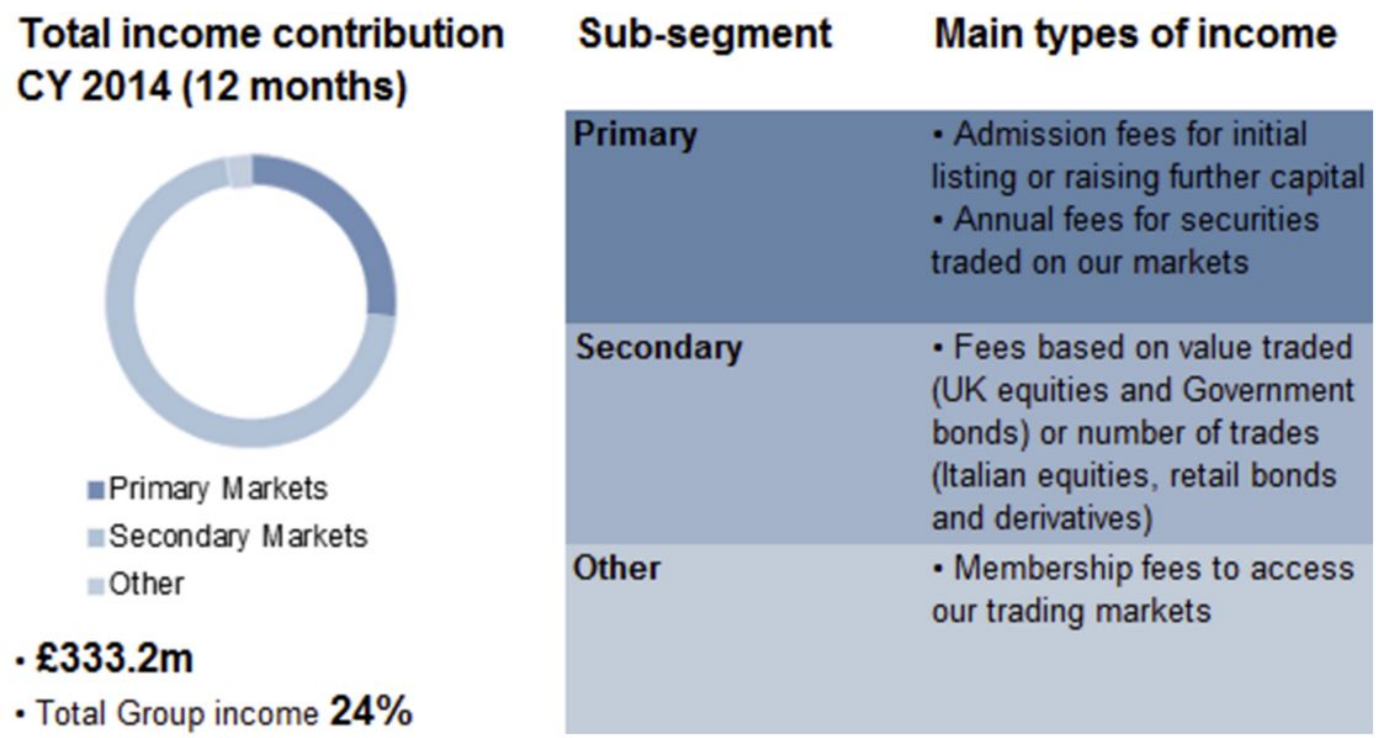
Source – LSE investor presentation

Divisional mix in 2014

Looking at the businesses and Capital Markets made up 24% of income in 2014 with the main area of revenue generation trading related. This area helps companies raise capital in the UK and Italy with the group owning Borsa Italiana.

This is a very cyclical business as depressed conditions will hit trading revenue if they continue for a long-time. Primary revenue for initial listings and capital raisings tend to dry up completely in a downturn

Capital markets in 2014



Source – LSE website

Post Trade LCH.Clearnet generated 28% of group income in 2014 with the division providing clearing services. This mitigates counterparty risk and generates revenue from fees on trades.

Post Trade LCH.Clearnet in 2014

- **£389.4m**
- Total Group income **28%**

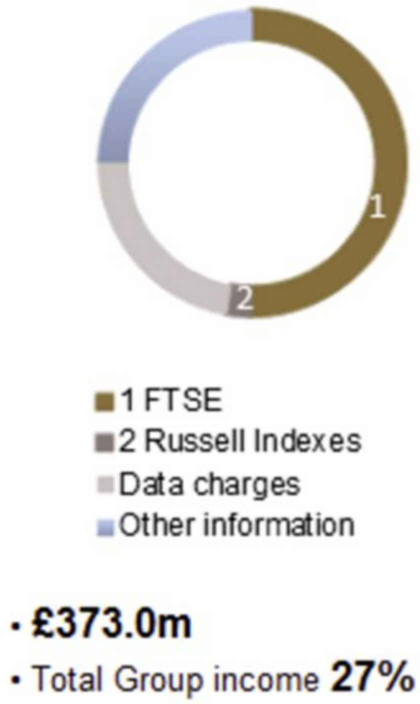
Clearing and other	• Fees based on trades or contracts cleared and CCP services provided • Fees for SwapClear interest rate swap service and other OTC derivative clearing primarily based on membership fees • Fees for managing non-cash collateral
Interest	• Net interest on cash held for margin and default funds

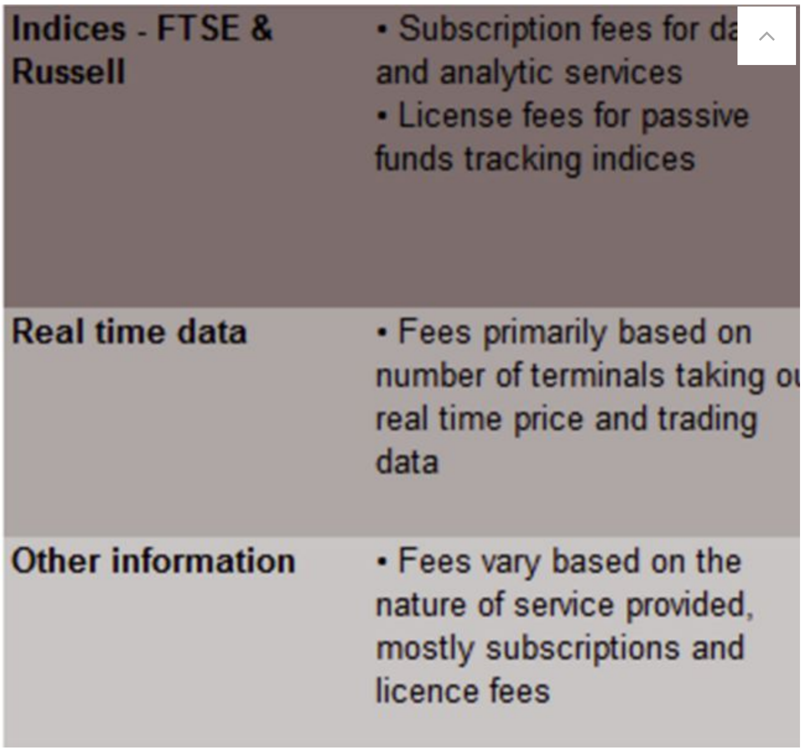
Source – LSE website

Information Services generated 27% of group income in 2014 and offers a wide range of data and information products. These include indices, real-time pricing, benchmarks, post trade analytics, reporting and reconciliation services.

A key area of growth is in license fees for passive funds tracking indices given the shift towards passive investment. As such Information Services should be a growth area for the group over the long-term.

Information Services in 2014





Indices - FTSE & Russell	• Subscription fees for da and analytic services • License fees for passive funds tracking indices
Real time data	• Fees primarily based on number of terminals taking o real time price and trading data
Other information	• Fees vary based on the nature of service provided, mostly subscriptions and licence fees

Source – LSE website

These three divisions together made up 79% of the LSE's income in 2014 and so are the main business drivers. The other divisions are Post Trade CC&G and Monte Titoli and Technology Services.

LSE Revenue drivers in H1 2015 – Information services

In taking over Frank Russell the group for £1.6bn not only bought the index business but also acquired Russell Investment management. The LSE has agreed to sell the asset management business for £752m to TA Associates.

The deal is expected to complete in the first quarter of 2016 and will reduce the LSE's pro-forma leverage to around 1.6X net debt to EBITDA. This compares to pro forma EBITDA to net debt at 2X at June 2015.

In assessing the group's revenue drivers it is therefore worth ignoring Russell Investment. What the Frank Russell acquisition has done is boost the LSE's Information Services division through the US focused Russell Index business.

LSE first half revenue generation – Information Services driver

	Six months ended 30 June 2015 £m	2014 £m	Variance %	Organic a constant currency variance[1] %
Revenue				
Capital Markets	**170.0**	171.2	(1%)	4%
Post Trade Services - CC&G and Monte Titoli	**46.8**	51.0	(8%)	3%
Post Trade Services - LCH.Clearnet	**149.1**	173.8	(14%)	(11%)
Information Services	**261.0**	180.0	45%	5%
Technology Services	**38.3**	32.8	17%	14%
Russell Investment Management (gross)	**497.3**	-	-	-
Other	**2.4**	2.7	(11%)	(8%)
Total revenue	**1,164.9**	611.5	90%	1%

Source – LSE investor presentation

The net effect is that Information Services is now by far the largest revenue contributor (excluding asset management) in the first half of 2015. This will help offset the cyclical nature of the Capital Markets division.

LSE's increasing focus on Information Services

The LSE held an investor day on 9th November 2015 to explain how it intends to take the Information Services division forward. CEO Xavier Rolet, described the company as an "infrastructure business" with three key areas.

These are Information Services, Post Trade and Capital market divisions with the first two the key drivers. Information Services was 37% of net income in the first nine months in 2015, Post Trade was 33% and Capital Markets was 24%.

The key information services brand will now be FTSE Russell Indexes and will see further cost synergies generated in 2016 and 2017. Revenue synergies are also targeted and will continue with US$48m targeted to 2019.

FTSE Russell Indexes – focus on integration and growth

- "FTSE Russell" global brand launched
- Integration making good progress:
  - Sales and marketing teams merged
  - Cost synergies **$78m** by end of year three – **on track**
  - Revenue synergies **$48m** by end of year five – **on track**
  - Integration costs $71m, mainly in 2015 & 2016

Source – LSE investor presentation

The London Stock Exchange's information services brand FTSE Russell competes with S&P and MSCI. The company has close to US$11 trillion under its benchmarks and has a critical mass in this area.

FTSE Russell is global and provides products for ETFs and asset management benchmarks. This contrasts with S&P and MSCI which either aren't global or only play in ETFs or asset management.

The growth of trading products and passive asset management are key drivers for FTSE Russell and the Information Services division. With FTSE Russell having a strong global market position it is well placed to deliver growth for the LSE.

Summary and valuation

The LSE has seen its shares fall by just under a quarter since hitting a peak of £27.80 at the end of 2015. Clearly, we can't rule out further price declines given the ongoing market volatility.

However, the valuation has started to become attractive at 17X forecast earnings for 2016 and 14.4X for 2017. The leading global brands, improvement in the quality of earnings and growth prospects all underpin the valuation.

The upcoming sale of Frank Russell asset management for £752m will also improve the strength of the balance sheet. As such the financial risks associated with the acquisition of Frank Russell will soon fall back.

In our view, the London Stock Exchange is a unique business that will benefit from the shift towards passive asset management. As acquisition savings and revenue synergies come through the valuation also becomes more modest.

In 2018 the forecast P/E is only 13X while in 2019 the forecast P/E falls to 11X earnings. While there are likely to be "bumps on the road" the strong market position of the LSE will continue to offer long-term resilience.

Accordingly, we recommend the London Stock Exchange as a medium-risk buy for all members.

America, Extra Space Storage, FedEx, Frasers Hospitality Trust, Guangzhou Automotive, Heineken, Harmony Gold, Hufvudstaden, Icade, Industrial Logistics Properties Trust, Inmobiliaria Colonial Intu Properties, Japan Airport Terminal, Land Securities Group, Meituan Dianping, MGM China, M Fudosan Co, National Storage, Nintendo, Office properties income Trust, Prologis, Retail Value, Sands China, Segro, Seritage Growth Properties, Site centres Corp, SMC Corp, Sony, SPDR Gold Trust, Spirit Reality Capital, Sumitomo Mitsui Financial, Tanger Factory Trust, Taubman Centres, Tencent, Vail Resorts, VanEck Vectors Gold Miners ETF, VanEck Vectors Junior Gold Miners ETF, Vereit, Vodafone, Vonovia, Vornado Reality, Trust, Walt Disney, Wharf Real Estate Investment Co, Wynn Macau, Wynn Resorts, Zillow, ZOZO. These may change without notice and should not be taken as recommendations.