

The Chicago Board Options Exchange (“CBOE”) is a U.S. derivatives exchange that operates several asset class trading platforms in the U.S. and Europe, including futures, equities, options, and foreign currency.

The company owns the CBOE Volatility Index (“VIX”), which has become the standard measure of volatility in the U.S. stock market. Trading volume in VIX contracts, which has been influenced in large part by both the creation and adoption of VIX-based ETFs, as well as its use as a common form of portfolio insurance/hedging, continues to grow every year, making it one of the more valuable derivatives contracts owned by any exchange in the world.

As the proprietary owner of the VIX, the CBOE holds great pricing power over this product. This is effectively a monopoly at the moment (although there is a competing volatility product anticipated to trade on another exchange in the near future), as options and futures contracts derived from the VIX cannot be traded on any other exchange. Taking advantage of this, the CBOE has structured a pricing system that essentially allows market participants to trade many of its listed options products at cost in exchange for the acceptance of a premium VIX contract pricing structure. Moreover, the company has the exclusive right to host the trading of the S&P 500 index options contract, providing it with further pricing power.

While equity and options trading has become somewhat commoditized over the last decade, the proprietary nature and value of the VIX franchise (as well as the regulatory license value of the futures exchange, the CFE) allows the CBOE to remain a key strategic asset within the exchange industry. Historically, this was always well reflected in the valuation, as the shares routinely traded in excess of 20x earnings.

However, as a result of the current stock market decline, CBOE now trades at 15.7x current year earnings estimates (though, estimates, at this point, are clearly subject to great uncertainty). At least over the short run, the exchanges are the primary beneficiaries of the ongoing capital markets volatility. For instance, on a year-to-date basis (through February 2020) the CBOE has reported the following volume increases in its various businesses: Options +42.5%, Futures +47.8%, and Equities +11.6%. This is not occurring just at the CBOE – virtually all U.S. exchanges are experiencing near record volumes this year, illustrating the quasi-countercyclical aspect of the business (which, of course, runs in reverse during periods of complacent market activity).

Thus, the underlying fundamental business of CBOE is performing magnificently well this year. Since this is predominantly a fixed cost business model (meaning, variable expenses do not, by and large, incrementally increase with volume or revenue expansion), the company could report near record earnings this year. This possibility is detached from the share price, which has declined by 35% in 2020. In the meantime, this is an extremely well capitalized company, with \$500 million in net debt and \$3.4

billion of shareholders' equity. It is in fact rare to find, in this environment, a company that is expanding earnings and cash flow almost every day, but by being a beneficiary of market volatility, the CBOE is certainly such an example.

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