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Rumors:

The newspapers are filled with rumors of Intercontinental Exchange (ICE) and/or Chicago Mercantile Exchange (CME) potentially making bids to acquire The London Stock Exchange. This follows news that Deutsche Bourse (DB1) is looking to create a pan-European marketplace by acquiring the London Stock Exchange (LSE). Of course, LSE has been "for sale" for quite sometime, so these news stories are not terribly surprising. With a $14 billion price tag, the acquisition is far from bite-sized. LSE trades at 20x 2017 earnings estimates, which is a premium valuation to CME. With this lofty valuation, a LSE acquisition would not be accretive for either US exchange.

Exchange transactions tend to work when the acquiring franchise can absorb the cheaper entity and enact large cost cuts. ICE has more European exposure, so it might be able to capture a higher amount of expense synergies. That being said, the European anti-trust environment might make this a very complicated deal. Looking at the bigger picture – a LSE transaction is not attractive on a valuation basis and it involves a very complex regulatory framework. Both of these issues make us question why either CME or ICE would really be interested in making a competing offer for LSE.

It might seem like a lifetime ago, but CME is an experienced exchange acquirer. CME acquired the Chicago Board of Trade (CBOT) in March of 2007 for $8 billion and then it purchased New York Mercantile Exchange (NYMEX) a year later for $11.2 billion. During both of CME's transactions, ICE made several attempts to act as a deal spoiler or interloper. In fact, when ICE acquired the iconic NYSE in 2013 for $8.2 billion, many market analysts were wondering if CME would somehow get involved. Both CME and ICE are experienced acquirers, but many of their deals have been US companies, US exchanges or US products. Acquiring international businesses can be tricky to execute and deliver on.

Various forms of *Leverage*:

In today's market, typical leverage is where a company adds debt or borrowed capital to its balance sheet to fund acquisitions (or its capital expenditures). With historically low interest rates, 2015 was one of the busiest years ever for mergers and acquisitions. As we examined 4th quarter 2015 results (in January and February), we noticed a few trends. The market seems to be struggling to deliver top line growth. Roughly 75% of companies in the S&P 500 exceeded earnings projections, but less than half beat their revenue expectations. Many companies are simply finding it difficult to grow and are attempting to cut costs to increase earnings. However, we understand that earnings can be flawed measures and that companies cannot cut their way to prosperity.

In addition, while companies are taking advantage of these low rates to lever up and grow, we do not believe bigger is better. Our preferred type of leverage follows the traditional definition - where an entity uses something to its maximum advantage. CME's operating leverage is unique and world-class. In our opinion, exchanges have a different perspective on balance sheet leverage. CME has a scalable platform that can absorb huge increases in volumes, without the added infrastructure costs. On its 1st quarter conference call, CME management articulated incremental operating margins that exceeded 90%. CME's Globex platform is capable of handling multitudes of existing volumes and has been tested to handle volumes well in excess of recent volatility spikes.

By acquiring CBOT and NYMEX, CME was able to add relevant products without also adding system complexity. It looked to leverage its scalable Globex platform. It already had a dominant share of the market participants trading on its systems. These deals made perfect sense to leverage the existing business model. While the timing was not ideal (pre-Financial crisis), but we are not sure if today either of these deals would pass regulatory scrutiny (especially with the current administration).

Back in the 1980's, the cable industry formulated an investment concept of the "big pipe". Once the infrastructure (or pipe) was laid, the industry would benefit with huge incremental margins. Throw in the concept of regulated monopolies and little competition, and one can understand why many of those businesses flourished. Today's exchanges are very similar.

Keeping it simple:

Unlike most financials, CME has a fairly straightforward business model. Even without a full understanding of complicated derivative strategies, an analyst can easily model this business in excel. On its website (www.cmegroup.com), any analyst can track a real-time tally of CME'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. Current expectations by management for expense growth remains muted in the low single digit range.

CME's deals in 2007 to 2008 led it to take on some debt, but it still has a very transparent balance sheet. This is especially true when you compare it to its banking and financial customers. As of last quarter, CME had debt of $2.2 billion versus cash equivalents of $1.2 billion. Quite simply, it has modest net debt of roughly $1 billion. Compared to its EBITDA estimate this year of $2.5 billion, CME is clearly not over levered. It has modest, regulatory cash requirements and management has deemed $700million of cash as the cushion it will keep on its balance sheet going forward. Its regulator, the CFTC, has blessed this level of cash as CME's necessary hurdle. As of today, there is over $525 million of excess cash and one can easily see CME generating another $1 billion of free cash flow this year. This should create an ample amount of excess cash to return to shareholders come January of 2017.

Valuation:

In terms of valuation, CME is far from overpriced. It currently trades 13.1x Enterprise Value to EBITDA. While this is a high valuation, we believe it is justified based on CME's dominant positioning and strong growth outlook. On a P/E basis, CME garners a 21x 2016 multiple. Looking at this year, the Street is expecting high single digit top line growth or roughly $3.6 billion in revenues.

During the most recent quarter, revenues grew 11% year-over-year with only a modest 3% growth in expenses. This type of positive operating leverage led to higher margins and 18% growth in earnings. Management is continuing to operate an "asset light model" and has announced the closing of its New York trading floor as well as the sale / leaseback of its data center. These decisions should lead to higher margins and increased cash levels.

This steady revenue growth should lead to mid-teens earnings growth or EPS of $4.35 per share. If one assumes higher volatility for CME's interest rate, energy and commodity products, revenue growth of mid-single digits would be somewhat conservative. Even keeping margins flat (another conservative estimate), CME could generate mid-teens earnings growth or $5.00 per share in 2017. Assigning its current year P/E to our 2017 estimate would yield 16% or high-teens upside from these levels. Combine that with a 5% dividend yield and the total return for CME shareholders could exceed 20%.

Fundamentals:

We seek to take advantage of disparities between a stock's current share price and its underlying intrinsic value. CME is at a particularly intriguing point in its growth. Volumes (the best indicator of growth and future revenue) are running quite high. Open interest, which is the best gauge for future volumes, is at an all-time high. Necessary infrastructure and capital costs to handle this future business have already been made. Over the next one to two years, CME

should be able to leverage their business model to generate excellent free cash flow. Operating margins, which are already at an impressive 65%, could potentially rise higher.

When a company's share price fully reflects the prospects for its business, offering us a fairly low return for the commensurate risk, we look to sell our position. CME is actually the opposite of this. CME's underlying fundamentals are positive and it has significant tailwinds ahead of it. Unlike a stock reflecting great fundamentals, CME has been a laggard of late. Over the last couple of years, CME has underperformed the overall market. Is this because the Street is expecting a LSE bid or another pricey acquisition? Is it because energy prices fell so dramatically or because interest rates have been stuck at essentially zero in the US? We do not know, but we absolutely do not believe we are over paying for CME at today's valuation. We believe CME is "on sale", especially for such a high quality company.

We seek to achieve long-term investment returns by identifying superior, growing businesses. One of our key tenets is that the equity markets offers premium return potential that can be captured through proprietary, in-depth research and security selection. It is our opinion that the Street is missing a wonderful business at an attractive valuation.

A higher yield than reported:

All management teams have a choice when redeploying excess free cash flow. Companies can choose to re-invest this capital in their own business, look to pay dividends or make strategic acquisitions. Over the last 4 years, CME's board has opted to do all three. However, the dominant focus of free cash flow has been to dramatically increase its dividend. We see no reason why this philosophy will change, as the Street has widely embraced this philosophy.

Management remains committed to returning cash to shareholders through its standard dividend program, as well as its unusual variable dividend policy.

Five years ago, the Board decided to return excess cash to shareholders. Cash on the balance sheet, in excess of CME's $700 million threshold, gets returned to patient shareholders in January. Over the last four years, CME's dividend yield has exceeded 5%.

Characteristics matter:

What we look for in a stock is exactly the opposite of a CME Globex trader. We are business buyers and investors, not short-term traders. Globex traders are looking for vast amounts of supply at low transaction costs. We focus on strong, durable franchise businesses with identifiable growth prospects and excellent management teams. These traders are looking to access the world's largest marketplace to find a seller or buyer to take the other side of their bet or hedge. Our investment process seeks to identify growth businesses with certain key attributes. These include high barriers to entry, market share leadership, pricing power or flexibility, recurring revenues and predictable free cash flow. CME's end customers are not terribly attractive to us, but CME's business characteristics are spot on for our philosophy. We have found that investing in companies with these durable competitive advantages, leads to outperformance. CME has all of these attractive characteristics and more.

Interest Rates:

Following the financial crisis, The Fed needed to respond with historic measures. Recessions and bubbles come from excess. We believe that the US is in recovery mode and not even in its expansion phase yet. Zero interest rates (or ZIRP) were a function of the financial crisis and are no longer warranted. We are now seven years removed from this crisis and the economy has stabilized. The US economy does not need to be on "life support" and is slowly and steadily improving. This led to the first of hopefully several rate increases - for the 1st time in a decade, the Fed in December of 2015 decided to raise US interest rates. Such increases would indicate that the US economy is growing and continuing to improve.

Other markets are easing, as they look to spur economic growth. As China releases a new 5-year plan and digests its decelerating growth, the global markets should be volatile. Global markets are truly intertwined and correlations are higher today than ever before. This market uncertainty is wonderful for an exchange that trades rates and CME does not just trade interest rates, it is the dominant exchange for trading short or long-dated rates.

For CME, interest rates represented 48% of 2015 transactions and roughly 25% of its annual revenue. During the 1st quarter of 2016, interest rates were 27% of total revenue and revenue grew at a steady 14% year-over-year. As we look forward to the back half of the year, the market is unsure of when or if the Fed will act. This uncertainty and volatility has been excellent for CME's April volumes - which were up 11% from a year ago. Open interest, the best leading indicator of future growth, is at an all-time high and up 23% year-over-year.

Energy:

Energy trading represents roughly 20% of CME's revenue. During the most recent quarter, ADV grew 18% and revenues climbed 14% year-over-year. Looking at current trends, April volumes are up an impressive 38% year-over-year. Open interest is also at an all-time high, which will bode well for future volumes.

Overall, commodity prices have struggled. Many experts believe this might continue, while others believe that the bottom has already recently happened. We tend not to make macro calls. It is our opinion that commodities will continue to experience significant volatility. The global environment leads us to this conclusion. Many emerging and developing countries are struggling to deliver growth, which should act as a cap on commodity prices. Without the incremental Chinese buyer, some commodities are going to find it difficult to get pricing. However, there are additional and unusual forces impacting supply.

First of all, US oil producers need to continue to drill (despite the lower price) to pay off their debt burden. Some governments need to continue to pump oil, to support inflated spending initiatives (e.g. Russia and Saudi Arabia). Add to this OPEC statements that it plans on abandoning its traditional role as a price stabilizer. OPEC seems content on continuing to pump oil despite these fairly low prices. The recent Doha energy summit failed to deliver any organized plan by OPEC members. Saudi Arabia is playing a multi-faceted chess game where it seeks to crush US production and financially impact its Middle Eastern rivals (primarily Iran). In addition, the US has lifted sanctions against Iran. After years of being excluded from the global oil markets, Iran plans on dramatically increasing their production. Factor in slack Chinese demand (which previously buoyed prices) and one can easily understand the dramatic fall in energy prices.

All of this leads us to believe that the price of oil will remain quite volatile for some time. The days of $100 barrels of oil seem very far away. As we write this (mid-April), WTI and Brent hover around $40 per barrel – almost at prices from a decade ago. Once again, CME benefits from this uncertainty. As more market participants argue about where WTI or Brent oil is headed, they will look towards the dominant exchange to make their transactions. One should expect higher levels of volatility and record volumes in various commodities this year.

Europe (and acquisitions) can be complicated:

While the combination of LSE and DB presents an interesting combination, it will be years before this merged entity can compete with CME. We believe this merger will lead to additional and messy regulatory constraints in Europe. While we expect CME management to examine every interesting asset that is available for sale, it is our belief that the cost and risk significantly outweighs the benefit and reward. CME understands the value of taking a deep dive into the numbers, if for no other reason than to gain a better understanding of a competitor. In addition, European transactions tend to have significant

regulatory restraints and worries. When the dust settles, we do not envision CME making a bid for LSE. Considering the cloud the stock has been under (possibly due to their rumored involvement), we believe it presents an interesting opportunity for long-term investors.

Risks:

Where could we be wrong? The management team of CME could pursue a costly deal for LSE. It could decide to make a bold statement by doubling down on an aggressive European franchise. This would complicate CME's regulatory environment and present a number of difficult legal challenges. In addition, CME would be increasing its exposure to a worse business – cash equities. The derivative franchise that CME dominates is a simpler business, with less competition and much higher operating margins. Could CME decide to put valuable management attention and capital towards this deal? It is possible, but we do not believe it is likely.

Last week, on the Intercontinental Exchange's conference call, management mentioned it was bypassing a bid for LSE. While ICE's 1q'16 results were solid, it rallied 7% in a down tape. We believe there was some built up pressure and worry that ICE would attempt to make a costly bid LSE. We believe the same case could be made for CME, if they mentioned that they were not interested in LSE.

In terms of capital, CME management was early and bold in dramatically increasing its dividend payout ratio. Instead of pursuing deals and buying back its own stock, management has diverted its free cash flow to an attractive 5% dividend yield. Additional acquisitions are a possibility, but CME has mostly pursued small, tuck-in deals. Altering its dividend policy is a possibility, but we do not believe management would backtrack from the successful process it began a few years ago.

In terms of price, we attempted to model conservative estimates for calculating a valuation target. If volatility dries up or if the market simply becomes more one sided, these estimates might prove aggressive. While we do not forecast a significant reduction in volatility this summer, it certainly is a possibility.

Conclusion:

The world continues to struggle with modest growth rates, little inflationary pressure and volatile social and political issues. We feel it is wise to invest in franchises that benefit from this uncertainty. Recent weakness has created an interesting opportunity to invest in a superior growth company, especially since growth is scarce. CME will become one of the best ways to benefit from higher levels of volatility.

CME's compelling business model cannot be replicated through exchange consolidation. It has an unmatched and diversified portfolio of products. It captures interest rates, equities, energy, agricultural commodities, metals and foreign exchange. Over the last four decades, few companies can claim long-term growth matching CME's mid-teens volume increases. CME's ADV has a CAGR of +14% from 1972 through 2015.

While most financials are opaque, CME is a transparent business model posting its volumes for all to easily view and track. Looking forward, CME will benefit from several secular growth drivers. It is experiencing solid growth in its core business of futures and options trading. The investment in globalization is starting to pay dividends, with international ADV growing over 24% in the most recent quarter. Lastly, management has accurately assessed the marketplace and has been at the forefront of returning excess capital to shareholders. Its unique dividend structure and variable 5th dividend policy has led to this impressive 5% dividend yield. We believe these company characteristics and future outlook bode well for the share price to reflect the underlying company fundamentals. Shareholders receive twice the yield of a

10 year US Treasury and above market growth rates. In our opinion, CME offers significant upside from these levels.

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