

CME Group Inc

US regional bank distress provides a new growth opportunity for CME

Maintain Rating: UNDERPERFORM | PO: 160.00 USD | Price: 182.71 USD

Almost \$2T deposits are held by banks who don't hedge

Using 4Q22 call report data from the Federal Financial Institutions Examination Council (FFIEC), we calculate that 9.6% (or \$1.8T) of aggregate deposits are held by banks that do not have interest rate hedging programs in place. Following the closure of Silicon Valley Bank and Signature Bank, the exposure of depository institutions to interest rate risk has come into focus. These firms had meaningful mark-to-market losses on their securities portfolios, and their predicament does not appear to be unique. Following this high-profile bank crisis, we believe that both management teams and regulators are likely to re-evaluate bank exposure to interest rate risk, and we may see a wider proliferation of hedging among smaller depository institutions.

Forecast a ~\$100M revenue opportunity for CME

Assuming turnover and fees in-line with the historical average, we estimate that CME Group (CME) could earn approximately \$100M in incremental revenue annually by penetrating the unhedged regional and community banks (Exhibit 1). Additionally, even among banks that do hedge, smaller banks appear to be underpenetrated and may have an opportunity to expand their existing hedging programs (Exhibit 3 & 4). Today, CME essentially has a monopoly on US interest rate futures trading, and therefore, derivative adoption will be directly accretive to their bottom line. Even if banks opt to hedge with interest rate swaps where CME has a much smaller footprint, we note that swap dealers will usually proceed to hedge their exposure with futures.

Incrementally positive but maintain Underperform

Although the regional banking crisis has been incrementally beneficial for CME due to its effect on hedging adoption as well as serving as a catalyst for volumes, we maintain our Underperform rating. As a result of CME's size, the full \$100M would translate into only 2% revenue accretion for 2023/24E. Given the high incremental margins on trading, the EPS tailwind should be modestly higher, but still not meaningful enough to upgrade our rating. We continue to believe that CME is expensive (23x 2024E earnings) relative to its organic growth (mid-single digit CAGR). Tradeweb (TW) would also incrementally benefit from this development, but given their smaller exposure to US interest rate derivatives vs CME (<20% of revenue vs 27% for CME in 2023E), the overall earnings impact should be even less material.

Estimates (Dec) (US\$)	2020A	2021A	2022E	2023E	2024E
EPS	6.73	6.69	7.97	8.35	7.99
GAAP EPS	6.72	NA	NA	NA	NA
EPS Change (YoY)	-1.0%	-0.6%	19.1%	4.8%	-4.3%
Consensus EPS (Bloomberg)			7.93	8.38	8.74
DPS	5.90	6.85	8.50	7.80	8.15
Valuation (Dec)					
P/E	27.1x	27.3x	22.9x	21.9x	22.9x
GAAP P/E	27.2x	NM	NM	NM	NM
Dividend Yield	3.2%	3.7%	4.7%	4.3%	4.5%

22 March 2023

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Stock Data

Price	182.71 USD
Price Objective	160.00 USD
Date Established	9-Feb-2023
Investment Opinion	B-3-7
52-Week Range	162.26 USD -245.45 USD
Mrkt Val / Shares Out (mn)	65,725 USD / 359.7
Average Daily Value	353.64 USD
BofA Ticker / Exchange	CME / NAS
Bloomberg / Reuters	CME US / CME.OQ
ROE (2022E)	10.5%
ESGMeter™	High

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Refer to important disclosures on page 6 to 9. Analyst Certification on page 4. Price Objective Basis/Risk on page 4.

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Timestamp: 22 March 2023 05:00AM EDT

iQprofileSM CME Group Inc

Income Statement Data (Dec)	2020A	2021A	2022E	2023E	2024E
(US\$ Millions)					
Total Net Revenue	4,884	4,687	5,019	5,159	5,016
% change	0.3%	-4.0%	7.1%	2.8%	-2.8%
Compensation & Benefit	(822)	(784)	(746)	(776)	(799)
% change	-5.0%	-4.6%	-4.9%	4.0%	3.0%
Non-Compensation Expenses	(980)	(921)	(1,026)	(1,073)	(1,093)
% change	3.7%	-6.0%	11.5%	4.5%	1.9%
Total Expenses	(1,801)	(1,705)	(1,772)	(1,849)	(1,892)
% change	-0.4%	-5.4%	4.0%	4.3%	2.3%
Operating Income	3,082	2,982	3,247	3,311	3,124
% change	0.8%	-3.3%	8.9%	2.0%	-5.6%
Reported Net Income	2,411	NA	NA	NA	NA
% change	-1.0%	NA	NA	NA	NA
Adjusted Net Income	2,413	2,400	2,863	3,005	2,881
% change	-0.9%	-0.5%	19.3%	4.9%	-4.1%

Performance Metrics (Dec)

	2020A	2021A	2022E	2023E	2024E
Operating Margin	63.1%	63.6%	64.7%	64.2%	62.3%
Compensation Expense/Revenue	16.8%	16.7%	14.9%	15.0%	15.9%
Non-Compensation Expense/Revenue	20.1%	19.6%	20.4%	20.8%	21.8%
Dividend Payout Ratio	87.5%	102.2%	106.5%	93.3%	101.9%

Balance Sheet Data (Dec)

(US\$ Millions)	2020A	2021A	2022E	2023E	2024E
Total Assets	124,660	196,780	177,146	177,345	177,288
Cash and Investments	1,633	2,835	844	1,020	944
Long-Term Debt	3,444	2,696	3,422	3,422	3,422
Total Shareholders' Equity	26,320	27,399	26,965	27,164	27,107

Company Sector

Other Financials

Company Description

CME, which was founded in 1898, is a leading derivatives exchange that handles more than 90% of U.S. futures trading. The company owns and operates multiple regulated exchanges, including the CBOT, NYMEX, COMEX, and KCBT. CME has grown both organically and via acquisitions and offers products such as futures and options on futures across all major asset classes (interest rates, equity indexes, energy, FX, metals, agricultural commodities, etc.), market data and clearing services.

Investment Rationale

CME stock is modestly overvalued relative to its long-term earnings growth and earnings quality. The current rebound in cyclical segments (rates, energy) are obscuring the tepid long-term growth rate of its largely mature businesses. The stock should trade more in-line with its core peer group (NDAQ, ICE).

Quarterly Earnings Estimates

	2021	2022
Q1	1.79A	2.11E
Q2	1.64A	1.97E
Q3	1.60A	1.98E
Q4	1.66A	1.92E

Bank hedging data

Exhibit 1: Estimating the CME's opportunity with unhedged banks

Regional & community bank hedging represents a ~\$100M white space

Aggregate deposits held by institutions that do not hedge	\$1.8T
Assumed notional value of a rates derivative contract	\$450k
Forecasted new open interest	4.1M
Est. annual turnover per contract	40x
Rates 2023E RPC	\$0.51

Annual Revenue Opportunity \$84M

Source: FFIEC, CME Group, BofA Global Research Estimates

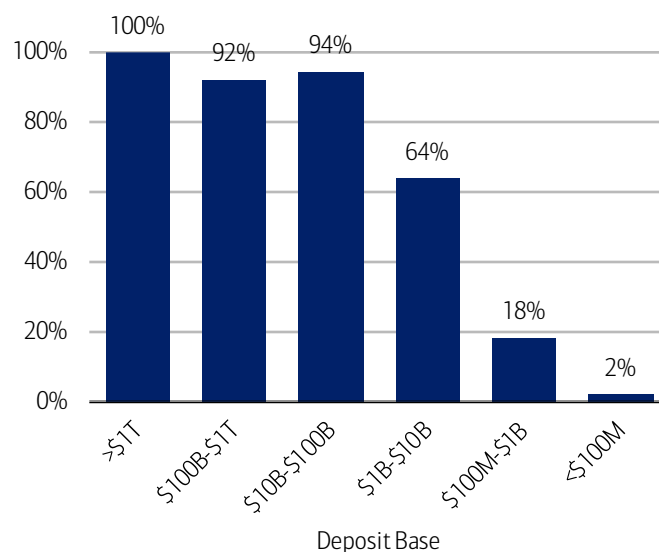
Note: Assumes a 1:1 ratio between deposits and notional derivative exposure

RPC = Revenue per contract

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Exhibit 2: % of banks that hedge interest rate risk

Most banks under \$10B of deposits do not hedge interest rates

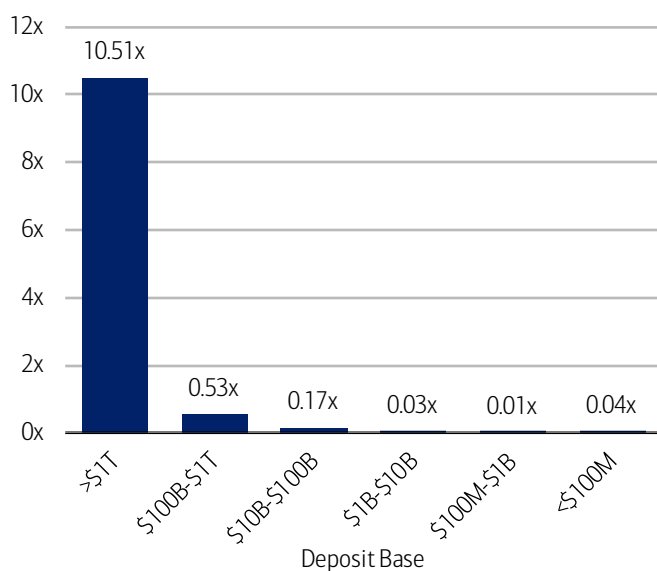


Source: FFIEC, BofA Global Research Estimates

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Exhibit 3: Median Hedge Coverage, Derivative Position vs Agg Deposits

Even if small banks have hedging policies, they often are less comprehensive



Source: FFIEC, BofA Global Research Estimates

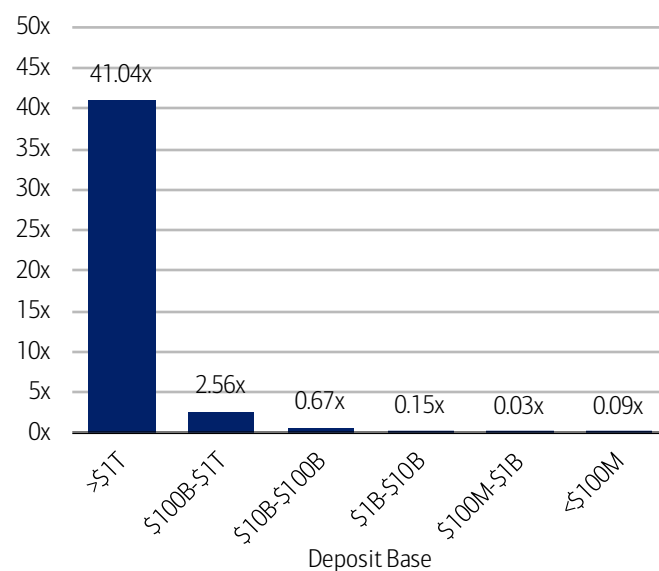
Notes: Unhedged banks were excluded for this analysis.

Hedge coverage = Gross notional interest rate exposure / Aggregate commercial bank deposits

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Exhibit 4: Median Hedge Coverage, Derivative Position vs Securities

Even if small banks have hedging policies, they often are less comprehensive



Source: FFIEC, BofA Global Research Estimates

Notes: Unhedged banks were excluded for this analysis.

Hedge coverage = Gross notional interest rate exposure / Book value of the securities portfolio

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Price objective basis & risk

CME Group Inc (CME)

Our primary valuation metric for US Exchanges is price to long-term earnings (2024E). We focus on long-term EPS because we prefer to normalize for any near-term factors, and it also provides credit for an additional two years of growth. We apply a 20x multiple on our 2024E EPS to derive our \$160 PO. Our multiple is based on the conservative assumption that CME trades in line with its peer group despite its lower growth prospects/earnings quality.

Downside risks are (1) depressed volumes, (2) lower earnings quality due to high transactional revenue composition, (3) mature markets and high market share stifling further growth, (4) trading at a premium to higher growth peers, (5) secular transition away from oil/fossil fuels where CME has high share and (6) regulatory risks (transaction tax, capital requirements).

Upside risks are (1) improving/elevated interest rate volumes due to quantitative tightening/inflation, (2) rebound in energy/metals volumes should there be a resolution in supply chain issues and the Russia/Ukraine conflict, (3) defensive qualities which drive stock outperformance in equity market drawdowns (e.g., 1Q22), and (4) potential for share gains in select markets: base metals after the LME debacle and cash after the DTCC cross-margining proposal is approved (estimated in 1Q23 versus 3Q22 prior target).

Tradeweb Markets Inc. (TW)

Our price objective (PO) for Tradeweb is derived from a price to earnings valuation method. We apply a 35x multiple on our 2024E EPS to derive our \$82 PO. Our 35x multiple is supported by TW's recent valuation range and assumes TW maintains a premium to the US exchanges due to higher visibility into its long-term growth trajectory combined with its defensive qualities.

Risks are (1) competitive pressures intensifying (MKT, Bloomberg, ICE, Trumid), (2) a high mix of transactional revenues, (3) secular pressure to trading commissions (although TW's commissions are still a low % of bid-ask), and (4) a high valuation relative to slower-growth peers.

Analyst Certification

I, Craig Siegenthaler, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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	Blackstone	BX	BX US	Craig Siegenthaler, CFA
	Blue Owl Capital	OWL	OWL US	Craig Siegenthaler, CFA
	Interactive Brokers	IBKR	IBKR US	Craig Siegenthaler, CFA
	Intercontinental Exchange	ICE	ICE US	Craig Siegenthaler, CFA
	KKR & Co. Inc.	KKR	KKR US	Craig Siegenthaler, CFA
	TPG Inc	TPG	TPG US	Craig Siegenthaler, CFA
	Tradeweb Markets Inc.	TW	TW US	Craig Siegenthaler, CFA
	Victory Capital Holdings, Inc.	VCTR	VCTR US	Craig Siegenthaler, CFA

US - Brokers, Asset Managers, & Exchanges Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
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	Invesco	IVZ	IVZ US	Craig Siegenthaler, CFA
	Janus Henderson Group	JHG	JHG US	Craig Siegenthaler, CFA
	Janus Henderson Group	JUHDY	JHG AU	Craig Siegenthaler, CFA
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	Nasdaq	NDAQ	NDAQ US	Craig Siegenthaler, CFA
	Robinhood Markets	HOOD	HOOD US	Craig Siegenthaler, CFA
	T. Rowe Price	TROW	TROW US	Craig Siegenthaler, CFA
	The Carlyle Group	CG	CG US	Craig Siegenthaler, CFA
RSTR				
	Focus Financial Partners	FOCS	FOCS US	Craig Siegenthaler, CFA

IQmethodSM Measures Definitions**Business Performance**

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

Numerator

NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

Denominator

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill

Amortization

Shareholders' Equity

Sales

N/A

N/A

Quality of Earnings

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

Numerator

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash & Equivalents

EBIT

Denominator

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

Valuation Toolkit

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

Numerator

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

EV = Current Share Price × Current Shares + Minority Equity + Net Debt +

Other LT Liabilities

Enterprise Value

Denominator

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

Market Cap = Current Share Price × Current Basic Shares

Sales

EV / EBITDA

Basic EBIT + Depreciation + Amortization

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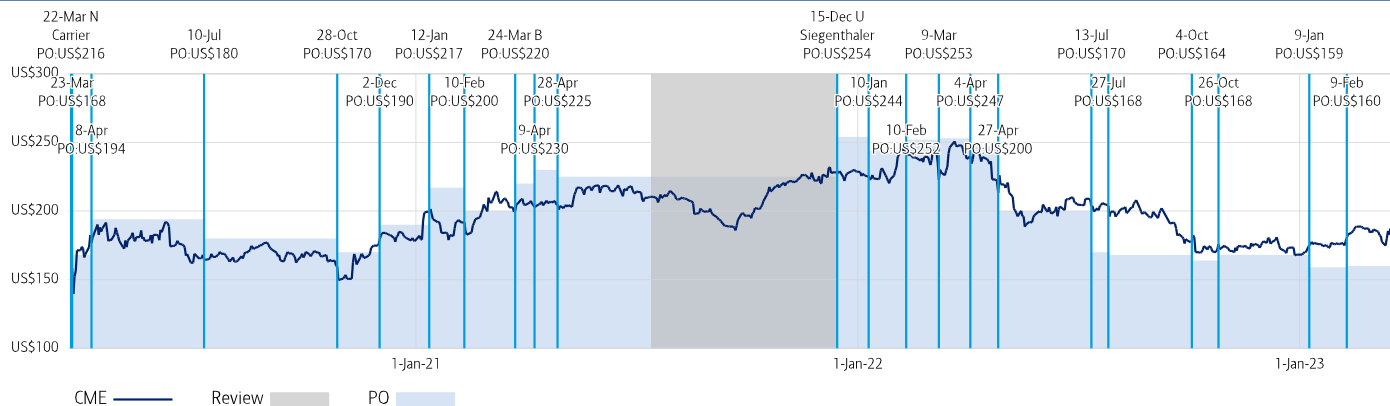
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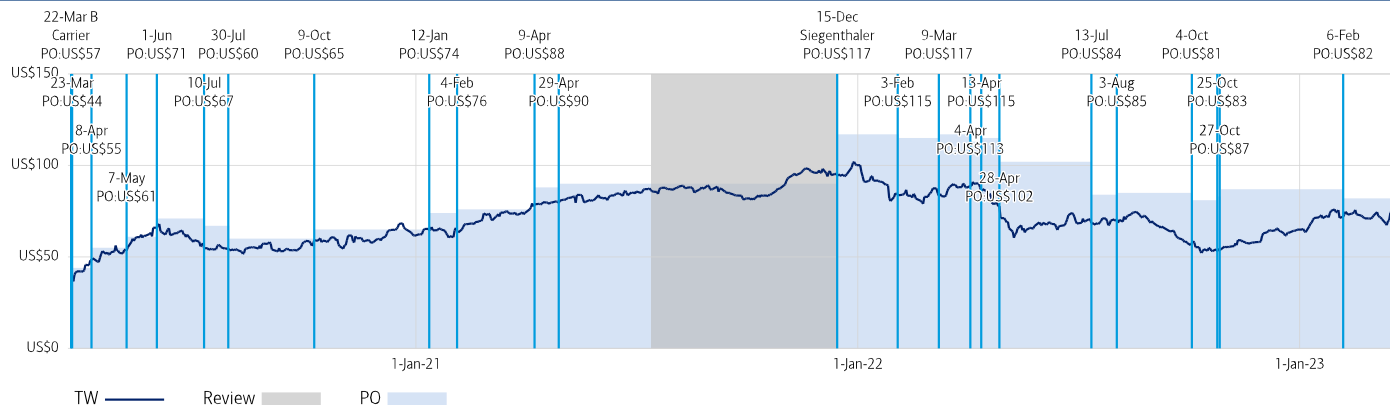
CME Group Inc (CME) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Tradeweb (TW) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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Equity Investment Rating Distribution: Financial Services Group (as of 31 Dec 2022)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	151	53.36%	Buy	100	66.23%
Hold	71	25.09%	Hold	43	60.56%
Sell	61	21.55%	Sell	42	68.85%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2022)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1853	52.58%	Buy	1040	56.13%
Hold	840	23.84%	Hold	493	58.69%
Sell	831	23.58%	Sell	404	48.62%

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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