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Total addressable hope

The levitating share prices of Tradeweb Markets, Inc. and MarketAxess Holdings, Inc. may point to the certain and final automation of the bond market—or to nothing more newsworthy than the familiar fact that EZ money is good for the stock market. Favoring the second interpretation over the first, *Grant's* is bearish on MarketAxess.

Now unfurling is a survey of the march of progress in fixed-income securities trading as that improvement bears on the outlook for our pair of hot stocks (TW and MKTX, each on the Nasdaq). A half-century ago, brokerage houses routed orders by pneumatic tube, traders guesstimated yields to maturity by referring to a basis book and bonds changed hands over the phone. Spreads were fat and the dealers, ditto.

The tubes and the book are gone, and the spreads have been eviscerated. But over-the-counter trading—sometimes with one human talking with another, for Pete's sake—persists, especially in block trading and still more especially in such differentiated corners of credit as junk bonds and emerging markets. Whether electronic bond trading will conquer all is the question before the house.

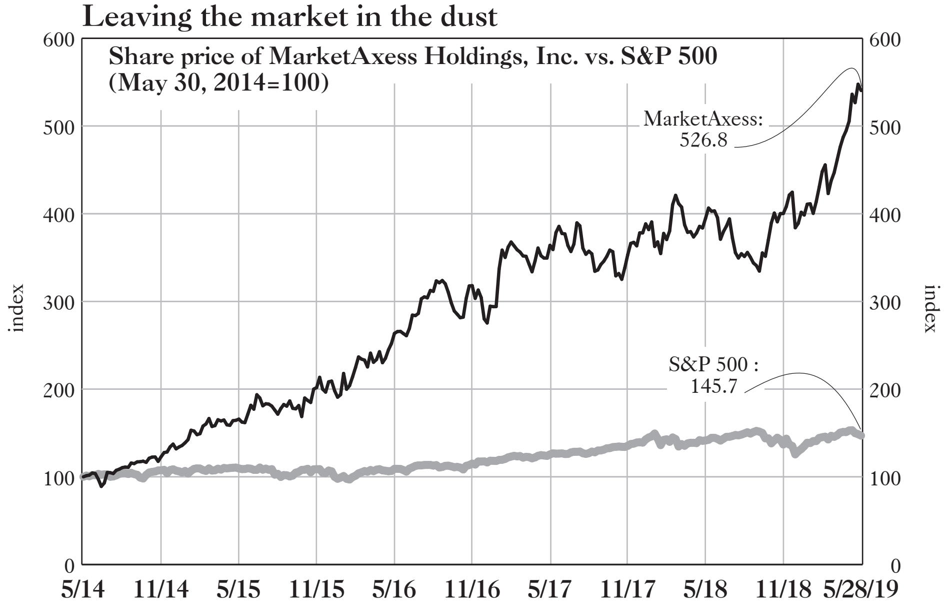
There are no such questions about stocks. International Business Machines Corp. has one primary equity line and one continuously quoted equity price. However, higher up the capital structure, there are 59 bonds, each with its own coupon, maturity date, covenant package and claim on corporate assets. The stock trades whenever the market is open, the bonds by appointment.

Financial repression and post-crisis financial regulation have made fixed-income trading even harder than it used to be. In the 11 years through 2018, nominal GDP grew by 42%, the volume of corporate bonds outstanding by 72%. Yet under the lash of post-crisis regulation, market-makers have shrunk or vanished. According to the New York Fed, primary dealers held $264.6 billion of corporate bonds in inventory at the end of 2007; they hold $23 billion today.

The digital entrepreneurs spotted opportunity long before Lehman fell. Tradeweb, a newcomer to the public markets—it was spun out of Refinitiv only last month—was founded in 1996 with a focus on Treasurys. In the first quarter, TW facilitated $646.6 billion's worth of trades, a 21% jump from the first three months of 2018. Revenues showed a year-over-year rise of 10.2%, to $186.8 million. Rates trading (government bonds and derivatives) chipped in 56% of the total, credit (e.g., corporate and municipal bonds) provided 21%, with equities, money markets, market-data sales and miscellany contributing the balance. In only two months, the share price is up by 60%.

As Tradeweb has a forte in government securities, MarketAxess excels in corporate credit. Four years younger than TW, MKTX has 15 years under its belt as a public company. In the first quarter, MarketAxess arranged trades worth $526.2 billion, up 13.2% from a year earlier, which drove an 8.5% gain in sales, to $124.5 million. Dollar-denominated, investment-grade bonds accounted for 49% of the total, other credit-sensitive debt obligations—EM debt, tax-exempts, euro-denominated

Leaving the market in the dust



source: The Bloomberg

corporate debt—provided 41%. Over the past five years, MKTX shares have delivered a cool 430%, far outpacing the 63% return of the S&P 500.

The bull case for our dynamic duo begins with the exponential arc of the two share prices—seeing is believing. It proceeds with the uncontested claims that electronic trading affords greater transparency, less scope for human error, an audit trail, a bigger liquidity pool and lower bid-ask spreads than legacy methods. And it continues with the datum, furnished by David Cresci, investor-relations manager at MKTX, that only 10% of what Cresci calls his company's "core market" is so far automated, or "electronified."

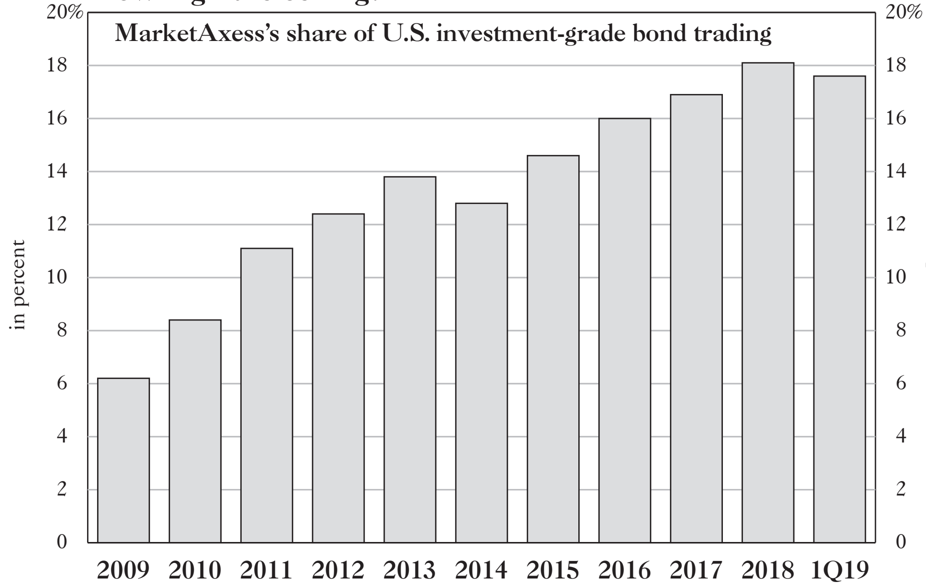
Quoted at 55.1 times estimated-2019 adjusted earnings per share, MarketAxess is clearly priced for the continued growth of that 10%; Tradeweb, quoted at 46.6 times the estimate, isn't far behind. To one bullish holder of the shares—he is George Livadas, founder and portfolio manager of Upslope Capital Management, of Englewood, Col.—there's little doubt that such growth will materialize.

"Over time," Livadas tells colleague Evan Lorenz, "people struggle to figure out your question of where this can go—what portion of the market can be electronic. They struggle to pinpoint where that number is, whether it is 50% or 75%, which is kind of where you hear people talk." He says that it's reasonable to expect MarketAxess to boost its penetration by at least 100 basis points a year. "I hate the phrase 'TAM,'" Livadas adds, referring to the private-equity buzz phrase "total addressable market," "but it is an easy TAM story for people to wrap their arms around."

The bull-side argument rounds out with the fact that each firm boasts net cash on the balance sheet, that MarketAxess could supposedly prove an attractive acquisition target even at the current valuation and that, anyway, alleged excessive valuation is the last refuge of a bear.

On, now, to the contrary case, which begins with a dog that hasn't barked. If "electronification" were destiny, you'd expect the Treasury market to be 100% wired by now. Government securities are undifferentiated with respect to credit, and there's certainly enough of them to trade—at $16.2 trillion, there are more marketable Treasury obligations than corporate ones ($9.2 trillion), even after adjusting for the holdings of the Fed and foreign central banks ($5.6 trillion). Yet, according to year-old data from the Securities Industry and Financial Markets Association, only 70% of the Treasury market transacts electronically.

How high the ceiling?



source: company reports

"Compare and contrast the Treasury market to the bewildering diversity of the corporate-bond market," Lorenz points out. "Coupons, covenant packages and maturity dates can vary widely from issuer to issuer and even (as noted with IBM's 59 flavors) within the issuance of a single borrower. Recently issued bonds of known borrowers are the easiest to trade and, as a result, 2% of U.S. investment-grade bonds account for about one-fifth of high-grade trading. This makes it fundamentally more difficult for credit markets to approach Treasury levels of electronic trading."

Besides, at least for now, bondholders are reluctant to expose large block orders to the electronic sunshine. "Some investors believe these platforms are not conducive to doing block-sized trades, particularly because if you put a block on one of these platforms, you are advertising it to the entire marketplace, and that has a cost in terms of information leakage," says Meghan Siripurapu, the senior fixed-income trader at Loomis, Sayles & Co. So, while MKTX and TW have made big inroads into odd-lot trading, they have yet to crack the 45% of credit trading that comprises block orders. To which a trader adds: "Unless the ticket size increases and you see more volume that way, without the introduction of new parties or disruptors, I don't see how market share is going to increase by 100 basis points or so every year." Altogether, the market opportunity in front of MKTX and TW may be more limited than bulls believe.

Then, too, if the stock market is any guide, electronification is no guarantee of ever-rising turnover—on the thoroughly digitized Big Board, equity volumes fell by 47% between 2007 and 2018. Nor is market drama invariably the broker's friend. Electronic bond trading seems to thrive with moderate volatility. Too much, and the brokers shut down.

"On the rare events where you have the flash crashes or liquidity situations," says a dealer who asks to go nameless, "almost all the guys turn off their auto-quoters. So you get into a situation where there is a period of 20–30 minutes or an hour where there is almost no liquidity on those platforms."

The volatility quotient of the late 2018 selloff was seemingly spot-on. At least, MKTX's share of U.S. investment-grade trading jumped to 19.3% in the fourth quarter, from 18.1% and 16.9% in the full years of 2018 and 2017, respectively. In the first three months of 2019, MKTX's share of high-grade bonds slipped to 17.6%. Tranquility poses its own problems.

Falling "capture rates" make another argument in the bearish brief. In the first quarter, turnover at MarketAxess grew by 13.2%, to $526.2 billion, from a year earlier, while revenue expanded by just 8.5%. In the same three months, a 21% jump in Tradeweb's volume translated into revenue growth of only 10.2%.

The flat yield curve may bear some of the blame for these falling capture rates (shorter-dated paper pays lower commissions than longer bonds). A more likely culprit is customers' growing preference for discounted monthly fees, known as distribution fees, as opposed to payment by the trade, known as variable fees. It's not necessarily a bad thing that steadier monthly revenue is contributing a rising share of the top line—to just that extent, MarketAxess and Tradeweb are protected against cyclical trading lulls. "However," as Lorenz points out, "at their current lofty multiples, shares in TW and MKTX are priced for growth, not downside protection."

"Since 2015, MKTX's cumulative capture rate has declined by 6% per year—partially offsetting higher volumes," Goldman Sachs analyst Alexander Blostein wrote in a November report, his first on MarketAxess. "We expect MKTX capture rates to see further declines of about 3% per year through 2020E amid mix shift, higher rates, move up in trade size and client switches from variable to distribution plans. Rising competition could put further pressure on our below-the-Street capture ratios." Blostein's verdict: Sell.

For all the efficiencies that they create, the electronic-payments platforms curiously lack pricing power. You can trade all you like on Bloomberg, L.P., for example, for the price of the terminal subscription (yes, the competition replies, but what you save on free commissions you lose with an inferior liquidity pool). Tradeweb, according to investor-relations spokesman Ashley Serrao, charges fees about 50% lower than MarketAxess's on investment-grade bond trading (TW is a relative newcomer to corporate credit with a newcomer's deficiencies in the depth of the liquidity provided). Over time, MarketAxess's fees themselves have decreased, to $169 per million dollars traded in the first quarter of 2019, from $172 per million in the first quarter of 2018 and $197 per million in the first three months of 2017. Five-year-old Trumid ("bringing trading efficiency and market intelligence to credit professionals") seems intent on adding to the competitive pressures.

Whatever else the growth in electronic trading has achieved, it's tended to concentrate market share in the handful of institutions that invest the most in information technology. "Dealers react by developing better pricing and autoquote models, mostly algorithm-driven," an executive at one of the 24 primary Treasury dealers tells Lorenz. "It takes a lot of IT investment. If you can't invest in the IT, you are falling behind."

MKTX and TW themselves run the risk of not keeping up. Last year, they spent $35.6 million and $43.7 million, respectively, on technology and research and development. JPMorgan Chase & Co. spent $8.8 billion. The ever-rising cost of running with the Morgans may help to explain why a growing number of hedge funds are outsourcing their trading needs to their favorite investment bank (as Bloomberg reported Tuesday morning). It's a trend that MarketAxess and Tradeweb are unlikely to cheer.

Central banks, with their demonstrated power to destroy price discovery, present a serious long-term risk to the integrity of bond markets, and therefore to the electronic platforms that facilitate trading. Come the next recession, the Federal Reserve should not fail to consider the expediency of pegging Treasury yields at various points along the curve, as it did in World War II. So Federal Reserve Governor Lael Brainard and Fed Vice Chairman Richard Clarida have proposed in separate speeches this year (*Grant's*, March 22). The Bank of Japan has been beating down bond prices since 2016 with the effect that whole days slip by without so much as a trade in some benchmark Japanese government bonds. On May 17, Toyota Motor Corp. joined a growing list of Japanese issuers that failed to issue all the bonds it had intended to sell to yield-deprived Japanese investors. Evidently, Mrs. Watanabe was not so famished that she was prepared to accept 15 basis points for 10 years, as Toyota had offered.

While both MarketAxess and Tradeweb may struggle to achieve the earnings growth that the stock market has discounted in their respective share prices, Tradeweb enjoys one paradoxical advantage over its more richly valued rival. A spin-out from Refinitiv, TW has begun its independent life with subpar margins of earnings before interest, taxes, depreciation and amortization: 43% in the latest period vs. 57% for MarketAxess, 63% for CME Group, Inc. and 52% for Intercontinental Exchange, Inc. Maybe the Tradeweb front office has plans to close the gap.

To extend its lead, MarketAxess would have to bring in enough new orders to lift the top line, something it has failed to do of late. As noted above, revenue growth slowed to 8.5% in the first quarter from full-year 2018 growth of 10.7% and five-year average growth of 12.8%. Analysts—who, as a class, are none too well-disposed to MarketAxess—have penciled in top-line improvement for both this year and next.

"Based on its growth trajectory," Lorenz winds up, "it is hard to explain the valuation premium that MarketAxess commands over other exchanges. The Intercontinental Exchange, CME and Nasdaq, Inc. trade at an average of 22.8 times their respective 2019 estimates. These three peers increased their revenues by an average of 5.5% year-over-year in the first quarter, only 300 basis points less than MarketAxess, which yet trades at more than twice their multiple.

"Short interest for MKTX stands at 5.6% of its float, that for TW at 2%. Even so, insiders and the Street are lukewarm about the pair. Over the past 12 months, MarketAxess insiders have unburdened themselves of 162,050 shares for net proceeds of $35 million. While Tradeweb's officers spent $2.4 million to acquire 8,850 shares at the initial public offering (giving them a $1.4 million mark-to-market gain in the post-IPO pop), the company's broker-dealer owners sold down their stake in the electronic marketplace to 24% of shares outstanding from 44.7% during the public listing. Of the 12 analysts who cover MarketAxess, 11 call it a hold. Of the 15 analysts who cover Tradeweb, 13 rate it a hold. 'Hold,' the faintest praise in the sell-side lexicon, seems well-deserved, especially in the case of MKTX, which is valued as if it had discovered a really, truly good veggie burger."

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