Multi Commodity Exchange of India Limited

CRISIL IPO Grade 5/5 (Strong)

January 06, 2012

Grading summary

CRISIL Research has reaffirmed CRISIL IPO grade of '5/5' (pronounced 'five on five') to the proposed initial public offer (IPO) of Multi Commodity Exchange of India Ltd (MCX). (CRISIL Research has undertaken a fresh grading exercise for MCX as the grade assigned to the company on June 15, 2011 had expired.) This grade indicates that the fundamentals of the IPO are **strong** relative to other listed equity securities in India. However, this grade is not an opinion on whether the issue price is appropriate in relation to the issue fundamentals. The grade is not a recommendation to buy, sell or hold the graded instrument, its future market price or suitability for a particular investor.

The grade reflects MCX's leadership position in the Indian commodity futures market over the past four years, with a share of ~82% of the overall traded turnover in FY11. It is a leader in the trading of bullion, crude oil, copper and natural gas (which accounted for ~85% of MCX's traded turnover in FY11). Historically, metals and energy commodities have witnessed lower regulatory intervention. With a strong technology-backed trading platform and infrastructure (supplied by its promoter Financial Technologies India Ltd), MCX is able to provide high liquidity and low impact cost of transactions – key criteria for the success of any exchange.

The grade takes into account the benefits that MCX will derive from amendments to the Forward Contracts (Regulation) Act, which will allow trading of options and indices, and participation by institutional investors, leading to increase in the traded turnover on commodity exchanges. The grade also draws support from MCX's strong management team and its ability to attract talented and experienced personnel.

While new commodity exchanges have been set up over the past couple of years, they have not been able to nudge MCX from the top. However, given the high profitability and cash-churning nature of the business, we expect competition to intensify in the future.

MCX's operating income has grown at a CAGR of 32% over FY09-11, with healthy profitability. EBITDA margin and adjusted PAT margin were 60.4% and 39.4%, respectively, in FY11.

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About the company

Mumbai-based Multi Commodity Exchange of India Ltd (MCX) is an electronic commodity futures exchange. Set up by Financial Technologies (India) Ltd (FTIL) as a demutualised exchange, it has permanent recognition from the Government of India to facilitate online trading, clearing and settlement operations for commodity futures across the country.

- ***Promoter background***

  MCX is promoted by FTIL with a pre-IPO stake of 31.18%. FTIL is a software developer and a technical service provider of automated electronic solutions in the areas of finance and technology like foreign exchange, commodities and equities. It is listed on the BSE, the NSE, the Ahmedabad Stock Exchange and the Madras Stock Exchange. The promoters of FTIL are Mr Jignesh Shah (18.1%), Mr Dewang Neralla (0.13%) and La-Fin Financial Services Private Ltd (26.5%).

Issue details

No. of shares being offered	6.4 mn (100% offer for sale)
As% of post issue equity	12.6%
Amount proposed to be raised	Not applicable
Objects of the issue	To achieve benefits of listing in order to enhance brand name and provide liquidity to existing shareholders
Price band	Not available at the time of grading
Lead managers	Edelweiss Financial Services Ltd., Citigroup Global Markets India Pvt. Ltd., Morgan Stanley India Pvt. Ltd.

Source: DRHP

Detailed Grading Rationale

A. Business Prospects

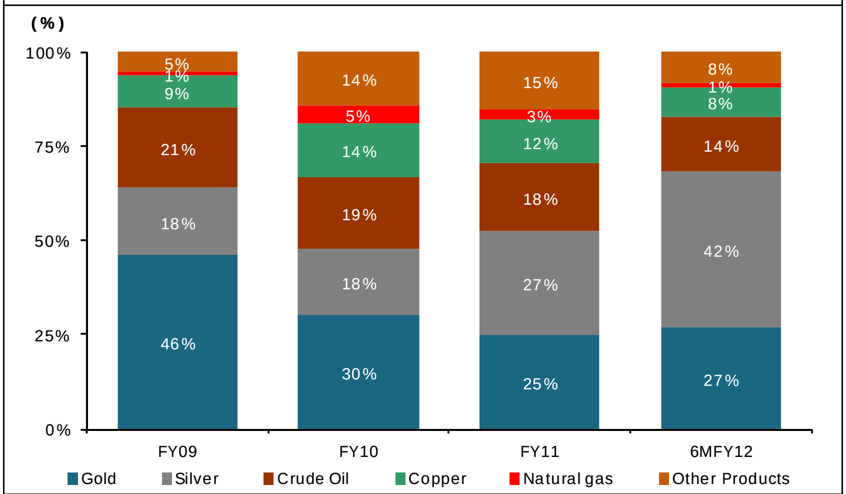
- ***Strong competitive position with 82% market share***

MCX's share in the overall commodities market has skyrocketed from 29% in FY04 to 82% as of FY11 primarily due to its focus on metals and energy commodities benchmarked to international prices. Globally, MCX is the largest silver exchange; the second largest gold, copper and natural gas exchange; and the third largest crude oil exchange in terms of the number of contracts traded in each of these commodities (in CY10 and six months ended June 30, 2011). It is also the sixth largest commodity exchange globally in CY10 and fifth largest during the six months ended June 30, 2011, in terms of the total number of contracts traded (Source: Futures Industry Association, websites of relevant exchanges). MCX has rooted itself firmly by continuously offering new and innovative products. Strong technology infrastructure and trading platform have helped MCX garner larger volumes, leading to high liquidity and lower impact cost – key criteria for the success of any exchange. Rapid growth in operations has been supported by best practices in risk management and strong technological backing provided by its promoter, FTIL.

- ***Product portfolio geared towards commodities linked to global price movements***

Around 85% of MCX's turnover is through metal and energy commodities which are benchmarked to international prices. Not only do these commodities have higher volumes but they also have higher turnover, which generates higher transaction fees compared to agricultural commodities. Historically, metal and energy commodities have also witnessed lower regulatory intervention.

Figure 1: Commodity-wise contribution based on traded value



Source: DRHP

- ***FTIL's expertise in exchange technology solutions bodes well for MCX***

Technology infrastructure is the foundation of any exchange business and a key factor for its development. MCX's electronic platform is supported by its infrastructure and advanced technology, allowing faster trade execution, anonymity, price transparency, prompt and reliable order routing, trade reporting, market data dissemination and market surveillance.

3

MCX's electronic trading platform is supplied by its promoter, FTIL, which is one of the leading technology companies in the development and deployment of exchange-related software and technology in India. Commodity exchanges operate in an environment which requires constant technology upgrade or variations and support due to changes required by the regulatory regime and market forces. FTIL's technical expertise and experience enables MCX to obtain speedy and efficient technology solutions, such as customisation and development of software for new products and services. However, FTIL's role as the promoter and MCX's significant dependence on FTIL for its technological requirement could potentially lead to a conflict of interest in the future. Post IPO, FTIL may own 26% of MCX's post-offer equity share capital. This is in compliance with the Forward Markets Commission's Equity Structure Guideline, which requires the original promoters to hold at least 15% and a maximum of 26% equity stake in a national commodity exchange.

- *Regulatory evolution will play an important role in industry growth*

The commodity futures market in India is in a nascent stage as trading in commodities was allowed only in 2002-03. Strong economic growth, introduction of new products and retail participation have driven commodities futures in India over the past decade.

CRISIL Research expects the growth pace to continue due to various changes expected on the regulatory front. The bill to amend the Forwards Contracts (Regulation) Act (FCRA) is yet to be passed by the government. Once the regulatory changes are in place, trading in options and indices are expected to drive the volumes on the exchange in line with the global trend. In the global commodities markets, options volumes constitute a significant proportion of traded volumes in commodity derivatives. The government has also been considering allowing foreign as well as domestic institutions and banks to participate in commodity futures trading. The entry of such participants, when permitted, is likely to be a positive for commodity exchanges like MCX, as it would help improve market liquidity. Currently, traders and brokers are the main participants on the exchange.

- *Competition likely to increase as new exchanges wrestle for share of volumes*

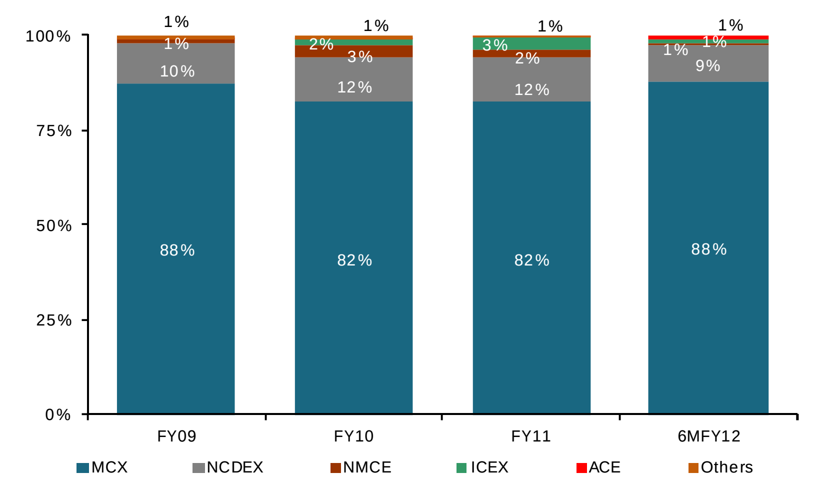
The buoyancy in the commodities market has evinced interest of new players. From three national commodity exchanges in 2008, at present there are five. Large financial institutions and corporate houses have entered this space, either as strategic or financial investors.

Table 1: Key competitors

Exchange	Year established	Key promoters / shareholders
National Commodities & Derivatives Exchange (NCDEX)	2003	Jaypee Capital, Shree Renuka Sugars, National Stock Exchange, Life Insurance Corporation, NABARD
National Multi Commodity Exchange of India (NMCE)	2003	Reliance Capital, Bajaj Investments & Holdings, Neptune Overseas, Punjab National Bank, Central Warehousing Corporation, Gujarat Agro Industries Corp., Gujarat State Agricultural Marketing Board, National Institute of Agricultural Marketing
Indian Commodity Exchange (ICEX)	2009	Reliance Exchangenext, MMTC, Indiabulls Financial Services, Indian Potash, KRIBHCO, IDFC
ACE Derivatives & Commodities Exchange	2010	Kotak Mahindra Group, Haryana State Cooperative Supply & Marketing Federation, Bank of Baroda, Corporation Bank, Union Bank

Source: Industry

Figure 2: Market share based on turnover



Source: DRHP

The commodity futures industry is characterised by significant specialisation. Exchanges generally develop a niche position in product categories based on the performance of the trade and product specification, and support mechanism provided by the exchange. Although there is no regulatory provision which prohibits trading of similar products on different exchanges, the market generally converges to a particular exchange with respect to a specific product, based on the product-related support and services that the exchange provides to market participants. That exchange would then further develop and enhance the product, thus creating a stronger foothold and carving out a niche for itself in that particular product. The liquidity provided by trading in a particular contract on an exchange, as described above, typically creates a competitive advantage for that exchange as compared to other exchanges considering offering competing contracts and also acts as an entry barrier for other exchanges.

While the number of national commodity exchanges has increased in recent years, the new exchanges have not been able to make a significant impact on MCX's market position. However, on account of high profitability and the cash-churning nature of the business, we expect competition to intensify in the future.

B. Financial Performance

MCX's sources of operating income are a) transaction fees, b) membership admission fees, c) annual subscription fees and d) terminal charges. Transaction fee is the largest contributor to operating revenue and its share has grown from 88% in FY09 to 96% in 6MFY12. MCX's operating revenue has grown at a CAGR of 32% over FY09-11, with much of the growth coming through transaction fees, which grew at a CAGR of 37% over the same period.

EBITDA margin improved to 60.4% in FY11 from 53.6% in FY09, on account of operating leverage – most of MCX's operating costs are fixed and semi-fixed in nature. Likewise, adjusted PAT margin also improved from 35.5% in FY09 to 39.4% in FY11. Return on equity decreased marginally from 24.4% in FY09 to 22.8% in FY11. We expect MCX to be able to sustain its profitability going forward due to slower growth in operating costs vs. revenue growth.

Table 2: Financial performance snapshot

Particulars	Unit	FY09	FY10	FY11	6M FY12
Operating income	Rs mn	2,124	2,874	3,689	2,728
Other income	Rs mn	806	694	787	441
EBITDA	Rs mn	1,570	2,110	2,704	2,226
EBITDA margin	%	53.6	59.1	60.4	70.3
Exceptional income[1]	Rs mn	728	1,369	-	-
PAT	Rs mn	1,588	2,208	1,763	1,490
Adjusted PAT	Rs mn	1,041	1,273	1,763	1,490
Adjusted PAT margin	%	35.5%	35.7%	39.4%	47.0%
Networth	Rs mn	4,937	6,968	8,488	10,050
No. of diluted equity shares[2]	Mn	51	51	51	51
Book value per share	Rs	97	137	166	197
Key ratios					
Return on equity[3]	%	24.4%	21.4%	22.8%	32.2
Return on capital employed[4]	%	32.2%	31.3%	31.8%	45.1

Note: Financials have been reclassified as per CRISIL standards

Source: DRHP

Table 3: Operating Revenue break-down

	FY09		FY10		FY11		6M FY12	
Category	Rs mn	%	Rs mn	%	Rs mn	%	Rs mn	%
Transaction fees	1,861	88	2,641	92	3,495	95	2,617	96
Membership admission fees	105	5	70	2	35	1	34	1
Annual subscription fees	136	6	136	5	135	4	67	2
Terminal charges	22	1	27	1	24	1	9	0
Total	**2,124**	**100**	**2,874**	**100**	**3,689**	**100**	**2,728**	**100**

Source: DRHP

MCX holds long-term investments in other operational exchanges – MCX Stock Exchange Ltd (5% equity stake as permissible under MIMPS Regulations) and Dubai Gold and Commodities Exchange Ltd (5% equity stake). MCX also holds 634 mn warrants in MCX-SX, which carry no voting or dividend rights. The company may generate more cash as and when it decides to liquidate these investments.

[1] Exceptional income includes profit on sale of long-term investments – Rs 1,369 mn in FY10 and Rs 728 mn in FY09 pertaining to stake sale in MCX Stock Exchange and Dubai Gold and Commodities Exchange. Adjusted PAT, return on equity and return on capital employed have been computed after excluding the impact of these transactions.

[2] Adjusted for 4:1 bonus shares issuance and stock consolidation in March 2011. Shares outstanding prior to the offer are 50,998,369

[3] Return on equity for 6MFY12 is annualised

[4] Return on capital employed for 6MFY12 is annualised

C. Management Capabilities and Corporate Governance

MCX's management is led by Mr Lambertus Rutten, who was joint managing director since June 2006, and took over as MD and CEO from Mr Joseph Massey in July 2009. Mr Massey, however, continues to be on the board of directors of MCX. Mr Rutten has previously worked as chief of finance, risk management and information in the commodities branch of the United Nations Conference on Trade and Development (UNCTAD), Geneva. Other key management personnel include Mr Parveen Singhal (deputy MD / non board), Mr Dipak Shah (director, market operations / non board), Mr Sumesh Parasrampuria (director, business development / non board), Mr P. Ramanathan (chief compliance officer and company secretary) and Mr Mahesh Joshi (chief financial officer). On the basis of our interactions, we believe that the senior management is highly competent in areas of product innovation, business development, regulatory understanding and risk management.

The board of directors consists of one executive director, six non executive directors and eight non executive independent directors. There are four nominee directors representing the Forward Markets Commission, one nominee director representing FTIL, one nominee director representing NABARD and one nominee director representing the State Bank of India. *(See Annexure II: Profile of the Directors)*

The board of directors includes Mr Venkat Chary, who is an independent director and also the chairman. He has previously worked in various capacities with Central and state governments including as the chairman of Forward Markets Commission (Government of India) as well as a member of the Maharashtra Electricity Regulatory Commission. Mr Jignesh Shah (part of the promoter group) is the non executive vice chairman. Some of the other independent directors are Mr C.M. Maniar (senior partner, Crawford Bayley & Co., Solicitors and Advocates), Mr Shvetal Vakil (executive director, Setco Automotive Ltd), Mr R.M. Premkumar (former chief secretary, Government of Maharashtra) and Mr K.T. Chacko (former Director General of Foreign Trade, Government of India).

The board members are highly experienced and come from varied backgrounds such as regulatory, entrepreneurship, legal, government administration and education. The independent directors have a good understanding of the business and their oversight responsibilities.

Annexure I

Business Profile

Having started operations in November 2003, MCX currently holds a market share of 82% of the Indian commodity futures market, and has more than 2,100 registered members operating through over 247,000 terminals (including CTCL), across India. MCX is also the fifth largest commodity futures exchange globally, in terms of the number of contracts traded during the six months ended June 30, 2011 (Source: Futures Industry Association, websites of relevant exchanges).

MCX offers more than 40 commodities across various classes such as bullion, ferrous and non-ferrous metals, and a number of agri-commodities on its platform. Globally, MCX is the largest silver exchange; the second largest gold, copper and natural gas exchange; and the third largest crude oil exchange in terms of the number of contracts traded in each of these commodities (in CY10).

Table 4: MCX: Turnover in major commodities (FY11)

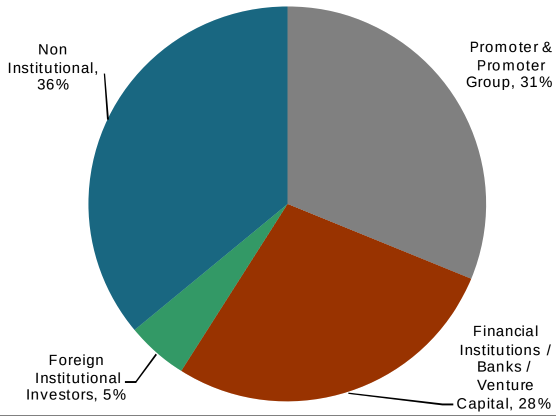
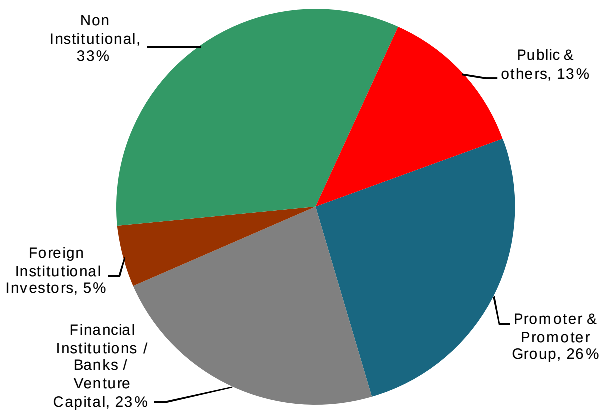
Commodity	Turnover (Rs bn)	Share in turnover
Gold	24,692	25%
Silver	27,000	27%
Crude oil	17,643	18%
Copper	11,451	12%
Natural gas	2,849	3%
Other products	14,780	15%
Total	**98,415**	**100%**

Source: DRHP

MCX has also pioneered several innovations in the Indian commodities market:

- MCX was the first national commodity futures exchange in India to offer futures trading in steel, crude oil and several other commodities, including carbon credits.
- In June 2005, it launched MCXCOMDEX, India's first real time composite commodity futures index, which provides MCX's members with valuable information regarding market movements in the key commodities, as determined by physical market size in India
- In December 2009, MCX launched the exchange of futures for physicals facility for the first time in India.
- In May 2010 and June 2010, the exchange launched zinc mini futures and lead mini futures contracts, which offer trading in these metals in smaller lot sizes.
- In January 2011, the exchange launched iron ore future contracts.
- In February 2011, it launched silver micro and aluminium mini contracts, which offer trading in these metals in smaller lot sizes.
- In April 2011, MCX launched gold petal contract which offers trading in gold in smaller lot sizes
- In October 2011, it launched the cotton (29 mm) futures contract
- MCX is also the first exchange in India to initiate evening sessions to synchronise with the trading hours of global exchanges in London, New York and other major international markets to meet the needs of the physical markets that operate in such time zones.

Shareholding pattern

Figure 3: Pre-issue shareholding pattern	Figure 4: Post-issue shareholding pattern
	
Source: DRHP	**Source: DRHP**

Annexure II: Profile of the Directors

Name	Designation	Age	Qualification	Experience & previous employments	Directorships in other entities*
Venkat Chary	Chairman, Non Executive Independent Director	71	IAS (Retired), M.Com, BA LLB and PG Diploma in Economics and Finance	• Chairman, Forward Markets Commission • Member, Maharashtra Electricity Regulatory Commission	• Indian Energy Exchange • Global Board of Trade, Mauritius
Jignesh P. Shah	Vice Chairman, Non Executive Non Independent Director	44	B.E., Mumbai University	• Bombay Stock Exchange	• Financial Technologies • MCX Stock Exchange • Indian Energy Exchange • National Spot Exchange • Singapore Mercantile Exchange • Bahrain Financial Exchange
V. Hariharan	Non Executive, Non Independent Director	52	Masters in Agricultural Statistics	• National Stock Exchange • NSE IT Ltd. • Premier Automobiles • Bombay Stock Exchange	• Singapore Mercantile Exchange • National Spot Exchange • MCX Stock Exchange • Indian Energy Exchange
Joseph Massey	Non Executive, Non Independent Director	50	Masters in Economics, Masters degree in Financial Management	• MD and CEO, Multi Commodity Exchange of India Ltd. • Managing Director, Interconnected Stock Exchange of India	• National Spot Exchange • Dubai Gold and Commodities Exchange • Indian Energy Exchange • Bahrain Financial Exchange
Lambertus Rutten	Managing Director and Chief Executive Officer	48	Masters in International Economic Management from Tilburg University, Netherlands	• Chief of Finance, Risk Management and Information in the Commodities Branch of the United Nations Conference on Trade and Development (UNCTAD), Geneva	• Bourse Africa • Swiss Futures & Options Association
P. G. Kakodkar	Non Executive, Non Independent Director	74	Master's Degree in Economics	• State Bank of Hyderabad • State Bank of Mysore • NABARD	• Financial Technologies • Goa Carbon • Uttam Galva Steels • Apian Finance & Investment • Fomento Resorts & Hotels
Paras Ajmera	Non Executive, Non Independent Director (FTIL Nominee)	39	B.E. Computer Science	• Director, Operations and Human Resources (Non Board), Financial Technologies	• Grameen Pragati Foundation • Takshashila Academia of Economic Research • National Bulk Handling Corporation • FT Group Investment (Mauritius) • SME Exchange of India
C. M. Maniar	Non Executive Independent Director	76	Masters in Economics & Political Science, BA LLB	• Senior Partner, Crawford Bayley & Co., Solicitors and Advocates	• Godfrey Phillips India • Gujarat Ambuja Exports • Hindalco Industries • Pioneer Investcorp • Varun Shipping • Vadilal Industries • Utkal Alumina International • Financial Technologies
Shvetal S. Vakil	Non Executive, Independent Director	60	B.Com	• Executive Director, Setco Automotive • Hindustan Lever • Bunge India	• Setco Automotive • TransStadia Technologies • TransStadia Hospitality

Name	Designation	Age	Qualification	Experience & previous employments	Directorships in other entities*
Usha Suresh	Non Executive, Independent Director (FMC Nominee)	49	PG in Economics	• Indian Economic Service • Planning Commission • Ministries of Rural Development Industry, Textile and Commerce	None
R.M. Premkumar	Non Executive, Independent Director (FMC Nominee)	66	B.A. Arts and Law, M.A.	• Chief Secretary, Govt. of Maharashtra • Principal Secretary Revenue, Govt. of Maharashtra • Development Commissioner, SEEPZ • Additional Secretary, DAE • Chairman, Food Corporation of India • MD, Maharashtra State Co-operative Bank	• Afcons Infrastructure • Fine Line Circuits • Pipavav Defence & Offshore Engineering • Rama Cylinders • SICOM • NTPC-BHEL Power Project • Lanco-Vidarbha Thermal Power
K. T. Chacko	Non Executive, Independent Director (FMC Nominee)	65	Masters in Public Administration from Harvard University, USA	• Director General of Foreign Trade, Govt. of India • Dept. of Commerce, Govt. of India	• National Centre for Trade Information
Ashima Goyal	Non Executive, Independent Director, (FMC Nominee)	56	PG and Doctorate in Economics	• Professor, Indira Gandhi Institute of Development Research	• MCX Stock Exchange • MCX-SX Clearing Corporation • Cynergy Creators
Srinivasan Balan	Non Executive, Independent Director (NABARD Nominee)	60	MBA, CFA, CAIIB	• Head, Finance, NABARD • Reserve Bank of India	None
B. Sriram	Non Executive, Non Independent Director (State Bank of India Nominee)	53	PG in Physics, Diploma in Management	• Chief General Manager, State Bank of India	• Gujarat State Energy Generation • HDFC Venture Capital

*Partial list of Directorships

Source: Company, DRHP