

## Why CBOE is Like a Shovel Maker During the Gold Rush

*(This is a guest post and may not reflect the views of Old School Value)*

| *“During the gold rush its a good time to be in the pick and shovel business.” – Mark Twain*

We start off with the Mark Twain quote because the idea is to find businesses in a booming industry that makes money no matter what happens.

If the [gold digging 49er](#) strikes it rich, you win.

If he doesn't, you still win.

If the macroeconomics of the industry is strong, the business is profitable. I have heard the CEO of one such “shovel maker” state:

| *We want to get in the way of the growth.*

As other businesses attempt to strike it rich, you want your business to be there to support their endeavors.

The winners in the gold rush will buy more of your products (or services) and the losers will fall off. As long as the industry as a whole is growing, the winner's growth will outpace the loser's downfall.

### CBOE is the Shovel Maker of Finance

CBOE Holdings (ticker: CBOE), operates the market where investors and speculators come together to invest in various derivative contracts.

They are the platform where literally trillions of dollars are traded each year.

CBOE does not engage in trading per say. They are just the intermediary and facilitate trades between others.

This means there is very little risk for a company like CBOE.

It is the classic “[heads I win, tails you lose](#)” situation.

Another beautiful part of the business is that their services are needed in any type of market.

In a hot market, investors are lining up to buy options to lever their returns.

In a down market, investors are lining up to profit on the



downturn.

In a sideways market, investors can profit from no movement.

It's a win win win.

On the flip side, their market attracts those that wish to protect their capital through various hedging strategies.

It's fun for all ages!

## **How Does CBOE Make Money?**

CBOE generates a majority of its money through transaction fees.

76% of their revenue is based on their exclusive license agreements regarding S&P 500 Index options (42%) and volatility based options and futures (36%) (*source: Valueline*).

In English, they get a cut of every trade that happens on these products without the risk.

For the numbers, I'll be using the [OSV Stock Analyzer](#).

CBOE has only been public since 2009 so that's why the numbers are from 2009 onwards.

Take a look at these fantastic numbers from the income statement.

CBOE Holdings, Inc. (CBOE)		Enter Ticker	Annual	Hide Chg %	Click to Watch Video Tutorial		old school value					
		Refresh	Quarterly	Show Chg %			Figures in Millions except					
August 24, 2014												
Annual Statements		2009	2010	2011	2012	2013	TTM					
<b>Income Statement</b>												
Revenue	\$	426.1	\$	437.1	\$	508.1	\$	512.3	\$	572.1	\$	580.4
Cost of Revenues	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
COGS (%)		0.0%		0.0%		0.0%		0.0%		0.0%		0.0%
Gross Profit	\$	426.1	\$	437.1	\$	508.1	\$	512.3	\$	572.1	\$	580.4
Gross Income (%)		100.0%		100.0%		100.0%		100.0%		100.0%		100.0%
<b>Operating Expenses</b>												
Selling, General & Admin. Expenses	\$	221.0	\$	230.3	\$	222.6	\$	236.8	\$	251.7	\$	254.8
SG&A (%)		51.9%		52.7%		43.8%		46.2%		44.0%		43.9%
Research & Development	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
R&D (%)		0.0%		0.0%		0.0%		0.0%		0.0%		0.0%
EBITDA	\$	205.1	\$	197.2	\$	275.7	\$	275.6	\$	320.3	\$	325.6
EBITDA (%)		48.1%		45.1%		54.3%		53.8%		56.0%		56.1%
Other Special Charges	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
Depreciation & Amortization	\$	27.5	\$	29.9	\$	34.1	\$	31.5	\$	34.5	\$	36.1
Depreciation & Amortization (%)		6.5%		6.8%		6.7%		6.1%		6.0%		6.2%
Operating Income	\$	205.1	\$	197.2	\$	275.7	\$	275.6	\$	320.3	\$	316.1
Operating Income (%)		48.1%		45.1%		54.3%		53.8%		56.0%		54.5%
<b>Other Income and Expense</b>												
EBIT	\$	177.9	\$	165.5	\$	240.9	\$	242.5	\$	283.5	\$	290.9
EBIT (%)		41.8%		37.9%		47.4%		47.3%		49.6%		50.1%
Interest Expense	\$	0.9	\$	0.9	\$	0.9	\$	-	\$	-	\$	-
Interest Income	\$	-	\$	0.5	\$	0.1	\$	0.1	\$	0.1	\$	0.1
Other Income	\$	1.6	\$	-	\$	-	\$	-	\$	-	\$	3.2
Total Other Income	\$	1.6	\$	0.5	\$	(0.6)	\$	0.2	\$	(0.5)	\$	3.0
Income Before Taxes (EBT)	\$	177.0	\$	164.6	\$	240.0	\$	242.5	\$	283.5	\$	290.9
Income Taxes/(Credit)	\$	70.8	\$	65.2	\$	100.7	\$	85.2	\$	107.7	\$	111.5
Tax Rate %		40.0%		39.6%		42.0%		35.1%		38.0%		38.3%
Earnings After Taxes	\$	106.2	\$	99.3	\$	139.3	\$	157.3	\$	175.9	\$	179.4
Minority Interest Expense	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
Net Income From Continuing Operations	\$	106.5	\$	99.4	\$	139.4	\$	157.4	\$	176.0	\$	179.5
Net Income From Discontinued Operations	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
Extraordinary Income/Losses	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
Income From Cumulated Effect Of Accounting Changes	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
Income From Tax Loss Carry Forward	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
Other Gains/Losses	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-
Net Income Total	\$	106.5	\$	99.4	\$	139.4	\$	157.4	\$	176.0	\$	179.5
Net Income (%)		25.0%		22.7%		27.4%		30.7%		30.8%		30.9%
<b>Shares and EPS</b>												
Total Basic EPS	\$	1.17	\$	1.04	\$	1.55	\$	1.80	\$	2.02	\$	2.07
Fully Diluted EPS	\$	1.17	\$	1.04	\$	1.55	\$	1.80	\$	2.02	\$	2.07
Dividends Paid Per Share	\$	-	\$	0.20	\$	0.44	\$	1.29	\$	1.16	\$	1.22
Basic Shares Outstanding		90.7		95.8		90.0		87.5		87.3		85.2
Diluted Shares Outstanding		90.7		95.8		90.0		87.5		87.3		85.8

CBOE's Excellent Income Statement | Enlarge ([source](#))

Some key points include:

Since CBOE is a platform, there are no COGS.

This is a fixed cost business. The platform is built and since it is almost entirely electronic, it is easily scalable. Any growth in revenue easily falls to the bottom line.

There is very little that needs to be done to get that next sale.

On the Balance Sheet, we see more great things.

		Annual	Hide Chg %	Click to Watch Video Tutorial			old school value		
		Quarterly	Show Chg %						
1									
2	<b>CBOE Holdings, Inc.</b>								
3	<b>(CBOE)</b>								
4	August 24, 2014								Figures in Millions except
73	<b>Balance Sheet</b>	2009	2010	2011	2012	2013	MRQ		
74	<b>Assets</b>								
75	Cash and Equiv	\$ 383.7	\$ 53.8	\$ 134.9	\$ 135.6	\$ 221.3	\$ 145.1		
77	Short-Term Investments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
79	Net Receivables	\$ 43.1	\$ 51.1	\$ 49.5	\$ 62.6	\$ 80.8	\$ 87.7		
81	Inventories, raw materials	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
83	Inventories, work in progress	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
85	Inventories, purchased components	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
87	Inventories, finished goods	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
89	Inventories, other	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
91	Inventories	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
93	Prepaid Expenses	\$ 5.8	\$ 4.5	\$ 4.2	\$ 4.1	\$ 4.0	\$ 9.6		
95	Current Deferred Income Taxes	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
97	Other Current Assets	\$ 0.5	\$ 0.5	\$ 1.1	\$ 0.6	\$ 2.7	\$ 1.5		
99	<b>Total Current Assets</b>	<b>\$ 433.1</b>	<b>\$ 109.9</b>	<b>\$ 189.7</b>	<b>\$ 202.9</b>	<b>\$ 308.9</b>	<b>\$ 243.9</b>		
101	Land and Improvements	\$ 4.9	\$ 4.9	\$ 4.9	\$ 4.9	\$ 4.9	\$ 4.9		
103	Building and Improvements	\$ 60.8	\$ 60.9	\$ 60.9	\$ 62.4	\$ 65.4	\$ 67.9		
105	Machinery, Furniture & Equipment	\$ 213.4	\$ 240.7	\$ -	\$ 263.2	\$ 271.4	\$ 279.6		
107	Construction in Progress	\$ 20.7	\$ 1.7	\$ 1.3	\$ 0.1	\$ 0.0	\$ -		
109	Other Fixed Assets	\$ -	\$ -	\$ 248.0	\$ -	\$ -	\$ -		
111	<b>Total Fixed Assets</b>	<b>\$ 299.8</b>	<b>\$ 308.3</b>	<b>\$ 315.1</b>	<b>\$ 330.6</b>	<b>\$ 341.8</b>	<b>\$ 352.4</b>		
113	<b>Net Fixed Assets</b>	<b>\$ 96.2</b>	<b>\$ 87.0</b>	<b>\$ 76.8</b>	<b>\$ 79.0</b>	<b>\$ 72.2</b>	<b>\$ 75.1</b>		
115	Intangible Assets	\$ 39.6	\$ 44.6	\$ 42.2	\$ 42.7	\$ 45.9	\$ 52.0		
117	Goodwill	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
119	Non Current Deferred Income Taxes	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
121	Other Long-Term Assets	\$ 3.1	\$ 12.6	\$ 19.2	\$ 14.3	\$ 14.6	\$ 14.7		
123	<b>Total Long-Term Assets</b>	<b>\$ 138.9</b>	<b>\$ 144.2</b>	<b>\$ 138.2</b>	<b>\$ 135.9</b>	<b>\$ 132.7</b>	<b>\$ 141.8</b>		
125	<b>Total Assets</b>	<b>\$ 571.9</b>	<b>\$ 254.1</b>	<b>\$ 327.9</b>	<b>\$ 338.9</b>	<b>\$ 441.6</b>	<b>\$ 385.8</b>		
127	<b>Liabilities &amp; Stockholders' Equity</b>								
128	Accounts payable	\$ 358.4	\$ 48.4	\$ 7.6	\$ 6.5	\$ 13.7	\$ 13.6		
130	Short-Term Debt + Notes Payable	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
132	Taxes Payable	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
134	Accrued Expenses	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
136	Accrued Liabilities	\$ -	\$ -	\$ 44.3	\$ 44.5	\$ 48.9	\$ 43.7		
138	Deferred Revenues	\$ 0.2	\$ 0.3	\$ 0.4	\$ 1.1	\$ 1.1	\$ 11.7		
140	Current Deferred Income Taxes	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
142	Other Current Liabilities	\$ 0.1	\$ 0.1	\$ -	\$ -	\$ 43.8	\$ -		
144	<b>Total Current Liabilities</b>	<b>\$ 358.7</b>	<b>\$ 48.8</b>	<b>\$ 52.3</b>	<b>\$ 52.2</b>	<b>\$ 107.5</b>	<b>\$ 69.0</b>		
146	Long-Term Debt	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
148	Other Liabilities	\$ 4.5	\$ 8.9	\$ 17.9	\$ 26.6	\$ 35.9	\$ 39.4		
150	Deferred Income Taxes	\$ 20.6	\$ 20.5	\$ 21.4	\$ 21.0	\$ 13.7	\$ 13.5		
152	<b>Total Long-Term Liabilities</b>	<b>\$ 25.1</b>	<b>\$ 29.4</b>	<b>\$ 39.3</b>	<b>\$ 47.6</b>	<b>\$ 49.6</b>	<b>\$ 52.9</b>		
154	<b>Total Liabilities</b>	<b>\$ 383.8</b>	<b>\$ 78.2</b>	<b>\$ 91.6</b>	<b>\$ 99.7</b>	<b>\$ 157.1</b>	<b>\$ 121.9</b>		
156	Retained Earnings	\$ 166.8	\$ 133.1	\$ 232.1	\$ 275.5	\$ 349.3	\$ 410.0		
158	Preferred Equity	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -		
160	<b>Total Equity</b>	<b>\$ 188.1</b>	<b>\$ 175.9</b>	<b>\$ 236.3</b>	<b>\$ 239.1</b>	<b>\$ 284.5</b>	<b>\$ 263.9</b>		
162	<b>Total Liabilities &amp; Equity</b>	<b>\$ 571.9</b>	<b>\$ 254.1</b>	<b>\$ 327.9</b>	<b>\$ 338.9</b>	<b>\$ 441.6</b>	<b>\$ 385.8</b>		

What a Balance Sheet Should Look Like | Enlarge

With a market cap of \$4.35B, CBOE has very few assets on the books to back it up.

This would be a concern, but their true assets are not counted.

The real asset CBOE holds is the network.

## The Real Economic Moat of CBOE

Institutions are plugged in and there is a very large switching cost for customers.

Coming off their network is both expensive for the physical changes AND in execution. Leaving the CBOE means not being able to play in that market.

This could lead to lost opportunities.

CBOE's customers need to have access to execute their strategies.

Think of this asset like [Facebook](#).

Facebook's network is valuable because everyone uses it. CBOE is valuable because traders are on it. For one to break away, it hurts them and has little impact on the network. Thus, everyone has an incentive to stay.

Unlike Facebook, the customers actually *need* to be on the network to put food on the table.

This is a [huge economic moat](#).

For a competitor to come in, they would have to build an identical network and provide the same optionality that the CBOE provides for less.

I liken it to a startup competing with Visa, MasterCard and AMEX.

In addition, they have no debt.

After all, there is not much to buy once the network is complete. All the profits are there for the shareholders.

I love this.

## **Cash is Gushing Out**

The Cash Flow Statement tells a similar story:

1		2		3		4	
CBOE Holdings, Inc.		Enter Ticker		Annual	Hide Chg %	Click to Watch Video Tutorial	
(CBOE)		Refresh		Quarterly	Show Chg %	%old school value	
August 24, 2014							
165 Cash Flows Statement		2009	2010	2011	2012	2013	TTM
<b>Cash Flows From Operating Activities</b>							
166	Net Income	\$ 106.5	\$ 99.4	\$ 139.4	\$ 157.4	\$ 176.0	\$ 179.5
167	Depreciation & Amortization	\$ 27.7	\$ 30.0	\$ 34.2	\$ 31.6	\$ 34.6	\$ 36.2
168	Deferred Income Taxes	\$ 1.4	\$ 0.0	\$ 0.9	\$ (0.5)	\$ (7.1)	\$ (5.6)
169	Operating Gains	\$ 0.9	\$ 0.8	\$ 1.6	\$ 1.7	\$ 2.0	\$ 2.4
170	Extraordinary Gains	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
171	(Incr) Decr. in Receivables	\$ 3.8	\$ (8.0)	\$ 1.6	\$ (13.1)	\$ (18.2)	\$ (7.6)
172	(Incr) Decr. in Inventories	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
173	(Incr) Decr. in Prepaid Expenses	\$ 0.5	\$ 0.5	\$ 0.7	\$ 0.0	\$ 0.1	\$ (1.4)
174	(Incr) Decr. in Other Current Assets	\$ 0.1	\$ (0.1)	\$ (0.5)	\$ 0.5	\$ (2.2)	\$ (0.9)
175	Decr. (Incr) in payables	\$ (8.2)	\$ (3.3)	\$ 5.8	\$ 1.2	\$ 9.2	\$ 2.9
176	Decr. (Incr) in Other Current Liabilities	\$ (0.2)	\$ 0.4	\$ 9.0	\$ 8.7	\$ 9.0	\$ 9.5
177	Decr. (Incr) in Other Working Capital	\$ (19.8)	\$ (7.1)	\$ (2.6)	\$ 0.8	\$ (0.1)	\$ (4.9)
178	Other Non Cash Items	\$ 0.2	\$ 22.4	\$ 13.1	\$ 12.3	\$ 21.1	\$ 18.8
179							
180	<b>Net Cash From Operating Activities</b>	\$ 112.8	\$ 134.9	\$ 203.1	\$ 200.5	\$ 224.4	\$ 228.8
<b>Cash Flows From Investing Activities</b>							
182	Sale of Long-term Investments	\$ 1.5	\$ -	\$ -	\$ -	\$ -	\$ -
183	Sale of Short-term Investments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
184	Capital Expenditures	\$ (38.0)	\$ (23.6)	\$ (29.1)	\$ (30.1)	\$ (28.7)	\$ (43.9)
185	Acquisitions	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
186	Sale of Assets	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
187	Purchase of Long-term Investments	\$ -	\$ (8.0)	\$ (1.3)	\$ (2.9)	\$ (2.5)	\$ (2.4)
188	Purchase of Short-term Investments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
189	Other Investing Changes, Net	\$ 26.2	\$ (1.0)	\$ 0.1	\$ -	\$ 0.0	\$ 0.0
190							
191	<b>Net Cash From Investing Activities</b>	\$ (10.3)	\$ (32.5)	\$ (30.3)	\$ (33.0)	\$ (31.2)	\$ (46.3)
<b>Cash Flows From Financing Activities</b>							
200	Issuance of Capital Stock	\$ -	\$ 301.2	\$ -	\$ -	\$ -	\$ -
201	Repurchase of Capital Stock	\$ -	\$ (300.4)	\$ (51.3)	\$ (52.9)	\$ (51.4)	\$ (141.9)
202	Net Issuance of Stock	\$ -	\$ 0.8	\$ (51.3)	\$ (52.9)	\$ (51.4)	\$ (141.9)
203	Issuance of Debt	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
204	Repayment of Debt	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
205	Net Issuance of Debt	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
206	Dividends Paid	\$ -	\$ (133.1)	\$ (40.4)	\$ (114.0)	\$ (58.4)	\$ (106.9)
207							
208	<b>Cash from Financing</b>	\$ (0.1)	\$ (432.3)	\$ (91.7)	\$ (166.9)	\$ (107.4)	\$ (245.1)
209	Cash at Beginning of the Period	\$ 281.4	\$ 383.7	\$ 53.8	\$ 134.9	\$ 135.6	\$ 215.0
210	Cash at End of the Period	\$ 383.7	\$ 53.8	\$ 134.9	\$ 135.6	\$ 221.3	\$ 158.7
211	Change in Cash	\$ 102.3	\$ (329.9)	\$ 81.1	\$ 0.7	\$ 85.7	\$ (62.7)
212							
<b>Free Cash Flow</b>							
213	Cash from Operations	\$ 112.8	\$ 134.9	\$ 203.1	\$ 200.5	\$ 224.4	\$ 228.8
214	Cap Ex	\$ 38.0	\$ 23.6	\$ 29.1	\$ 30.1	\$ 28.7	\$ 43.9
215	<b>Free Cash Flow</b>	\$ 74.8	\$ 111.4	\$ 174.0	\$ 170.5	\$ 195.7	\$ 184.8
216	Free Cash Flow to Equity (FCFE)	\$ 73.4	\$ 111.3	\$ 173.0	\$ 171.0	\$ 202.9	\$ 190.5
217	Owner Earnings FCF	\$ 120.2	\$ 145.9	\$ 143.6	\$ 173.2	\$ 205.1	\$ 193.0

Cash is just gushing out | Enlarge

All of CBOE's activities are financed organically.

Cash Flow from Operations has doubled in 5 years. CAPEX is only around \$30M/year for the last 5 years and there is very little new investment that needs to be made compared to what it brings in.

This translates into a shareholder win in the Cash Flow from Financing Activities.

CBOE is steadily [buying back the shares](#) it issued when it went public.

This is on top of a dividend.

They are rewarding shareholders and as a shareholder, I like being rewarded.

## Key Points, Fair Value and Conclusion

CBOE has a huge moat around its business. The derivative market is only going to get bigger. Derivatives are a Pandora's Box. Once it opens, you can't put it back in. This means long term steady growth.

The fundamentals are strong:

I am using a very low discount rate on this one given the stability of the fundamentals.

I see fair value at just over \$80.

This is a long term play.

I do not see CBOE as a short term trade, but as a core long-term holding that will slowly, but steadily appreciate.

## **Disclosure**

Author is long CBOE

## **About Dan Myers**

A converted value investor with a desire to hear as many ideas as possible on the subject of valuation. A believer that the best way to learn is to teach. You can follow his video's on YouTube as well as follow him on Twitter.

