Stock story: Interncontinental Exchange (aka ICE)

A pioneer of digitalised financial markets that owns the New York Stock Exchange among others.

In 1997, Jeff Sprecher of the US, who had spent years developing power plants, decided to provide transparent pricing to the US power market. Well before electronic trading of financial securities became the norm, Sprecher paid US$1 for a tech start-up so he could build a web-based trading platform.

For three years, Sprecher and his team met oil, natural-gas and power companies to learn what people sought in a trading platform. Some of the innovations that resulted included pre-trade credit limits, counterparty credit filters and electronic trade confirmations – novelties taken for granted now. By 2000, the trading platform was set for launch. Sprecher renamed the shell company Intercontinental Exchange to highlight the trading platform's ability to cross oceans, let alone borders.

In 2001, the International Petroleum Exchange of London wanted to evolve from floor to electronic trading. At the time, the exchange was a regional one that offered oil futures contracts and had less than 25% share of the global oil futures market. Intercontinental Exchange, which promotes itself as ICE, saw an opportunity to branch into energy futures and clearing and purchased the exchange. Thanks to the ability of ICE's platform to increase price transparency, handle high volumes efficiently and lower transaction costs, the volume of oil futures traded on what is now called ICE Futures Europe swelled. A regional exchange grew into a global one.

From 2007, the year ICE listed (with the ticker ICE), the company went on a buying spree of exchanges. The company snared the New York Board of Trade, which barters commodities such as cocoa, coffee and cotton, ChemConnect, which trades chemicals, and the Winnipeg Commodity Exchange, now ICE Futures Canada that mainly trades canola. A sign of ICE's ambitions was the company's failed bid that year for the commodities-based Chicago Board of Trade.

Undaunted, the ICE takeover quest continued such that ICE, which earned US$6.6 billion in revenue in fiscal 2020, owns an exchange arm that boasts 12 global exchanges and six clearing houses that service the energy, agricultural and financial sectors. The haul includes the purchase in 2013 of the New York Stock Exchange, the world's biggest by volume. Among feats, ICE hosts nearly 66% of the world's traded oil futures contracts and is the world's leading clearer in energy and credit defaults. On top of that, ICE's exchange arm manages key global benchmark contracts. This list includes Brent oil, Euribor, natural gas, sterling short and long rates and sugar barometers of performance.

In recent years, ICE has branched out such that the exchange business, which brought in 55% of ICE revenue in fiscal 2020, is one of three divisions. The second arm, responsible for 27% of revenue in fiscal 2020, is the fixed income and data services business that sells data and technology to help investors make and execute decisions. ICE assess prices for roughly three million fixed-income securities spanning about 150 countries in 73 currencies, as well as providing advanced analytics and indexes for fixed-income markets.

ICE's other business is mortgage technology, which pulled in the remaining 18% of revenue in fiscal 2020. This arm has digitalised the mortgage process to reduce costs and increase efficiencies. The ICE mortgage business is the largest to automate the entire process, is the industry's leading platform with more than 3,000 customers, partners and investors, and the industry's only loan registry. This platform offers significant growth potential as more US mortgage originators are expected to turn to ICE's digitised offering.

ICE is a promising investment in three ways. The first is that the exchanges and other businesses possess sustainable competitive advantages that form a daunting 'moat' for the parent company – where moat is a colloquial way to say a company is protected from competition. Most of ICE's earnings are derived from trading and clearing fees from the exchange businesses and linked data. These businesses are moated because they enjoy economies of scale, network effects and industry structure that intimidate would-be competitors. Another moat for ICE is that when it comes to derivatives and listing, there are limited substitutes. The holder of benchmark contracts is favoured in negotiations, even if others are seeking to undercut on price.

A second advantage ICE enjoys is that the company is vertically integrated – it controls the execution and clearing of contracts. This enables the company to exert pricing power, attract volumes, and improve counterparty and systemic risk management.

The other advantage that makes ICE an attractive investment is the company is well managed. While ICE has a history of

disrupting others, the Sprecher-led team has prevented ICE being disrupted. Management has steered the business towards attractive industry structures (derivatives exchanges), unique data sources and value-add analytics. As important, the team has largely directed ICE away from equities exchanges, where regulation and technology have upended the pricing power and volumes over the past 15 years. All up, ICE is well placed to provide compounded returns for its investors for the foreseeable future.

ICE, as do all businesses, faces risks. One is that the company's revenue is tied to trading volumes over which it has little influence. The fact that trading volumes often increase in turbulent and falling markets means that ICE is well placed to weather a market slump that falls short of a prolonged 'bear market' where trading was light. ICE's other risk is that its business is exposed to adverse changes to regulations. Moves by regulators to separate execution and clearing, and actions that might reduce trading volumes, would disrupt ICE's revenue. ICE is protected to some extent in this regard because regulators are aware that such moves against exchanges, especially ones that feature large derivatives trading, would boost trading costs, hamper innovation and, possibly, increase systemic risks.

ICE, thus, is well placed in a world where Sprecher's vision has helped electronic trading become the norm.

Sources: ICE filings and company website.

info@magellangroup.com.au +61 2 9235 4888