Company Name: IG Group PLC

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Price: £4.46
Market Cap: £1621mln
PE: (P/Ex Earnings): 11.88
Avg Daily Liquidity: £10.26mln

Background

IG Group PLC is the leading global provider of Contracts for Difference (CFDs) and spread betting to retail investors.

Contracts provided include single stock, indices, currencies and commodities. A range of risk management tools are available, including guaranteed stop losses. Customers are able to acquire leverage through the contracts provided.

IG's main markets are in the UK, Australia, Singapore and various European countries. The UK is the most mature and core market and international expansion has been rapid, over the last 5 years. It has a business model that is scalable, with a sizeable moat, and with relatively little capital required.

Business Strength

IG is market leader in nearly all its chosen markets. It maintains its competitive advantage through high IT and marketing spend. This is helping to build a global brand, and indeed IGs global websites had a revamp this month, so they are branded in the same way globally.

Bad debt levels are extremely low and well managed at around 1%.

The two key ways of building a competitive advantage are through IT and Marketing. IGs scale means it can spend more on these than any other firm, and it has continued to invest heavily, with spend growing in line with revenue growth, so that operating margins have remained relatively stable. If at any point, it judges that it can cut back on this spending, there should be a positive effect on margins.

It also has an excellent reputation for service, registering highly in many customer surveys.

Financial Assessment

Revenues have grown rapidly as the company has consolidated in its key markets and opened new offices. Undoubtedly earnings have been given a boost by the extreme volatility experienced in the financial markets over the last few years. Indications are that earnings in the current financial year will be roughly flat versus FY2012. Fluctuations in earnings are to be expected because of the nature of the business, but this should not detract from the powerful underlying growth story, strong returns on equity and large amount of free cash flow that is generated and distributed.

	2006	2007	2008	2009	2010	2011	2012
Sales	89	122	184	257	350	362	411
Operating Margin	49%	50%	48%	53%	41%	43%	45%
Return on Equity	23%	26%	30%	24%	23%	-6%	33%
Net Income	36	48	67	78	101	- 25	137
Free Cash Flow	133	259	13	53	85	69	183

Risks and Mitigants

The main risk to the business model is that regulatory actions in IGs markets make use of IGs products much less attractive. This has already occurred in Japan, where leverage rules were tightened, resulting in a write down of goodwill in 2011. There are also moves afoot in Singapore to tighten certain regulations. IG is confident that there are a number of mitigants in place, and that the effect will be minimal.

It is possible that IG could also benefit from regulation. For example, a "Tobin Tax" on certain financial transactions in Europe could push business their way.

IG could also benefit from the fact that it leads the industry in terms of protection against client monies – fully segregating all retail deposits. The Australian regulator is moving towards requiring all deposits to be segregated, which will hurt many of IGs competitors.

While the regulatory environment is extremely hostile towards financial institutions in general, it is very comforting that the spread betting industry has had relatively little attention. It is felt that the "worst" of the regulation and legislation, which retail spread betting is at the very fringe of, may now be in the past. However, this stock does come with a certain amount of "regulatory risk", which we feel is priced in.

The last few years, with their unprecedented volatility can be seen as an excellent "stress test" of the business model, and it has performed admirably.

Valuation

IGs income is uneven because it is correlated with financial market volatility. Profit growth will therefore come in waves, and in some years revenue growth may appear lacklustre or even shrink, purely because markets are subdued. This is what has occurred in H1 2012. We therefore look to long term growth trends when forecasting free cash flow, where we see an long term improvement in operating margins as IT and Marketing spend levels out.

We use a CAPM derived DF, and a more conservative 11.7% (RF + 10%), to discount estimated DCF.

	2013e	2014e	2015e	2016e	2017e	Term.
Sales	375	413	454	499	549	604
Operating Margin	45%	45%	45%	45%	45%	50%
Depreciation	12	13	14	15	16	20
Free Cash Flow	121	133	146	161	178	217
Discounted (CAPM)	114	119	124	129	135	4,838
Discounted (11.7%)	108	107	105	104	102	1,215

Sales Growth 10% ***Terminal Sales Growth: 2.5%***

	Value	Upside
Discounted (CAPM)	5,609	244%
Discounted (11.7%)	1,891	16%

Conclusion

IG Group is market leader in a rapidly growing segment. It has achieved a strong moat, requires little CAPEX and actively distributes cash via a high dividend payout ratio. Even on an extremely conservatively valued basis it has strong upside potential. The key driver of returns in the long term is regulatory risk, and ability to develop new markets.