CBOE HOLDINGS, INC.
Prepared Remarks for First Quarter 2014 Earnings Call
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Good morning and thank you for joining us for our first quarter 2014 earnings conference call. On the call today, Ed Tilly, our CEO, will provide an update on our strategic initiatives for 2014. Then, Alan Dean, our Executive Vice President and CFO, will review our first quarter 2014 financial results. Following their comments, we will open the call to Q&A. Also joining us for Q&A is our President and COO, Ed Provost.

In addition, I'd like to point out that this presentation will include the use of several slides. We will be showing the slides and providing commentary on each. A downloadable copy of the slide presentation is available on the investor relations portion of our website.

As a preliminary note, you should be aware that this presentation contains forward-looking statements, which represent our current judgment on what the future may hold, and while we believe these judgments are reasonable, these forward-looking statements are not guarantees of future performance and involve certain assumptions, risks and uncertainties. Actual outcomes and results may differ materially from what is expressed or implied in any forward-looking statements. Please refer to our filings with the SEC for a full discussion of the factors that may affect any forward-looking statements. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise, after this conference call.

Now, I'd like to turn the call over to Ed Tilly.

Good morning and thank you for joining us today.

Before discussing CBOE's progress in the first quarter, I will take a moment for a few words about high frequency trading as it relates to or, more to the point, how it does not relate to the options market.

We operate in a highly regulated, transparent market with matching algorithms and fees that are clearly designed to benefit retail customers. It is important to note that the options market is, in many key ways, fundamentally different than the equities market. One result of these differences is that the options market does not cater to the HFT practices described in the Lewis book. For example, dark pools do not exist in the options market, the maker-taker transaction pricing model is not the dominant fee structure in the options market and even less so at CBOE, and customer orders primarily trade against quotes that are supplied by dedicated liquidity providers.

At CBOE, our size-based matching algorithm primarily rewards larger sized bids and offers, not the fastest bids and offers. Additionally, CBOE does not house its primary data center in a CBOE-owned building for which we can derive significant revenue via co-location. Further, our rulebook makes clear that CBOE employs very traditional options order types and does not offer particularly exotic or complicated orders in our marketplace.

While no one can say for certain how the current analysis of HFT might shape market structure, it remains our view that the potential financial impact to CBOE will not be material. We also believe there could potentially be some positive benefits that accrue to CBOE if reform leads to increased trading in lit markets. With that, I will move on to our first quarter results.

Double-digit volume increases across each of our product categories in the first quarter of 2014 resulted in record revenue and earnings for CBOE Holdings. Average daily volume for options and futures combined was 5.6 million contracts per day in the first quarter, up 15 percent over the previous quarter and 29 percent over the first quarter 2013. Options volume averaged 5.4

million contracts daily, up 14 percent over the previous quarter and 29 percent over 2013. Index options trading, led by strong trading in our SPX complex and record volume in VIX options, increased 17 percent both quarter-over-quarter and year-over-year.

Moving on now to our strategic initiatives for 2014, which fall into three main categories: leveraging and developing proprietary products, optimizing revenue in commoditized products, and broadening our customer base -- while maintaining the highest standards in market regulation.

As outlined in our last call, we plan to grow SPX trading in 2014 through intensified educational and marketing initiatives aimed at the following user groups: users of SPY options and SPY Weeklys who lack awareness of the benefits of SPX relative to SPY; institutional investors -- such as OTC users, pension funds, asset managers and insurance companies - who are just beginning to trade listed SPX; and overseas investors, who can use SPX and SPX Weeklys to hedge global economic risk or to efficiently take a position in the U.S. market.

I am pleased to report that ADV in the first quarter for our SPX product line was nearly 878,000 contracts, up eight percent over the previous year and seven percent over the previous quarter. SPX Weeklys continue to post double-digit gains as ADV reached a new high of 277,000 contracts, up 59 percent year over year and 33 percent over the previous quarter. Weeklys trading has brought a growing base of retail and semi-pro customers to our SPX marketplace and we see significant opportunity to further develop this new user base.

Turning now to trading in VIX options and futures, which posted all-time volume records in the first quarter. VIX options volume averaged 774,000 contracts per day, up 35 percent over the previous quarter and 22 percent over the first quarter of 2013. Average daily volume in VIX futures was nearly 203,000 contracts, an increase of 32 percent from the previous quarter and 33 percent from last year. We seem to field a question or two in every call regarding our view of the growth trajectory for VIX trading, so I will take a few moments here to provide some color.

The broad, sustained waves of growth in VIX trading are consistent with what we've seen in early stages of a ground-breaking product line - one that not only changes what people trade, but where and how they trade it. CBOE has developed three such product lines, equity options, index options and now VIX futures and options. It has been our experience that early growth in a game-changing product line is measured, not in years, but in decades.

In previous calls, we've highlighted new VIX users and today I'll take a bit of a deeper dive. It's helpful to think in terms of "Vega," when sizing the growing volatility market. Vega refers to how the price of an option can move in response to a one percent change in its implied volatility. Trading of VIX contracts now averages between 200 and 250 million dollars in vega daily. This is roughly 10 times the vega traded through OTC vol swaps and about one-and-a-half to 2 times the daily vega traded in listed SPX options.

Anyone who trades an option or manages a portfolio has volatility exposure. VIX futures and options clearly have become the preferred means for managing that volatility, but we are still in the early stages of growing that marketplace. Many customers are just beginning to determine how pure volatility trading fits into their various investment frameworks. And, as more investors enter this market, they continue to find compelling new trading opportunities that further expand the marketplace.

For instance, there is a growing recognition among asset managers that SPX and VIX derivatives are complementary risk management tools that can be used to construct very nuanced and precise portfolio hedges. SPX options provide directional exposure, while VIX futures and options provide a more dynamic hedge in fast changing markets. The whole notion of "harvesting" risk premium has taken on new meaning as sophisticated traders treat VIX and SPX derivatives as interchangeable components of their alpha-generating strategies.

Volatility arbitrage, though not new, has taken on a new dimension as several new hedge funds have begun to deploy strategies involving VIX futures and options.

We've seen the VIX universe continue to expand in surprising ways. For instance, a major investment group that principally trades energy and interest rates products recently became a trading privilege holder (TPH) at CFE.

Other new users include European investors trading VIX products against VSTOXX, a measure of volatility of the EURO STOXX 50, and Banks in Brazil now actively using VIX products for macro hedging. We also see increasing numbers of customers that sell implied volatility short, which has been an active topic in many trading forums.

It is important to note we are still in the early stages of developing previously identified customer segments globally, such as hedge funds, CTAs, proprietary trading firms, and institutional investors. Many customers in these categories are early adopters, meaning there is considerable room to further expand every category of VIX user.

Quite simply, we believe investors of every type can potentially benefit from the added dimension of pure volatility provided by VIX futures and options and that education is the key to unlocking that potential.

We continue to see tremendous demand for education in VIX trading. As an example, CBOE's Options Institute recently conducted seminars on VIX options and futures in New York, San Jose and Chicago, where over 650 individuals registered for three-hour courses. Our online classes are also highly subscribed and VIX-related webinars attract more viewers than any other topic. Additionally, given the ongoing mainstreaming of VIX trading, the Institute sees particular demand for VIX-related content from retail brokerage firms.

Our social media programs similarly reflect the great interest for all things related to the CBOE volatility index (VIX). VIX topics dominate online chatter and VIX-related blogs generate more page views than any other topic at The Options Hub, our online social media center. In one recent week, when our content was predominately VIX related, the site had a record 13,000 page views, more than double the usual number.

CBOE's Risk Management Conference (RMC) brings us face to face with some of our most active and sophisticated VIX customers. This year's event drew more than 320 participants and record corporate sponsorships for a content-rich program focused on options and VIX-related strategies and trends. A roundtable held at RMC, "VIX Success Drives Vol Market Forward," featured leading industry authorities -- I think it's fair to say this group was extremely enthusiastic about the evolving uses for VIX options and futures. We now look forward to holding similar sessions at our 3rd annual RMC Europe, which will be held September 3rd through the 5th, just outside of Dublin.

Broadening access to our marketplace is another avenue for further growth in VIX trading. As you know, we extended the VIX futures trading day by five hours and 45 minutes late in 2013. The added hours respond to demand for additional trading time for U.S. customers and enable European-based customers to access VIX futures during their local trading hours.

I'm pleased to say that some 15,000 VIX futures contracts per day now trade outside of regular U.S. trading hours, accounting for 7.4 percent of the product's total daily volume year to date. And, on certain days when overseas events triggered overnight volatility, we've seen the percentage rise as high as 15 percent.

Pending regulatory review, on June 22, we plan to further expand our extended trading hours to nearly 24 hours, which will accommodate Asian market hours and a growing worldwide user base. We also look forward to extending trading hours for VIX options, as well as SPX options, later this year, pending regulatory approval.

New product development represents a significant opportunity for us to continue to grow VIX trading. As you know, we launched futures on our new Short-Term VIX Index (VXST) in February, followed by the launch of Short-Term VIX options last month.

Short-Term VIX futures and options leverage the most compelling features of SPX Weeklys and VIX futures and options, including weekly expirations that enable traders to fine tune the timing of their volatility trades. Short-Term VIX is generally more volatile than VIX, which sets the stage for additional trading opportunities.

While we would like to have a better volume story at this point, we have not had the liquidity provider participation we expected early on, which has impacted market quality. Our concentration over the next 30-days will be on working with liquidity providers who plan to trade but are not yet actively quoting in this market. We believe traction will grow as market quality improves. In addition, CBOE is working with issuers of exchange-traded products (ETPs) who have expressed interest in developing products linked to VXST futures, similar to what we saw in VIX with VXX and other ETPs. So despite a slower start than we hoped, we remain very optimistic on the inherent utility of these products.

Other VIX product developments in the pipeline for 2014 include futures on the CBOE/CBOT 10-year U.S. Treasury Note Volatility Index, the first volatility index based on U.S. government debt. The VXTYN Index is calculated by applying our VIX methodology to futures options data from CME Group's 10-year U.S. Treasury note contract. We began disseminating the index values in May 2013 and, pending regulatory review, intend to launch futures on the index by the end of this year.

Diversifying our VIX product line across asset classes is an area where we see significant headroom for growth. We view interest-rate volatility as an exciting new frontier in the volatility marketplace.

Turning now to equity options trading, where CBOE continues to hold the industry lead in market share. In March 2014, CBOE and C2 accounted for 29.5 percent of all options traded. As of March 31, CBOE held 28.0 percent of total industry market share, adjusted for dividend trades, up slightly from the 27.9 percent total market share at the end of December. In multiply-listed options only, CBOE held 20.8 percent market share, up slightly from 20.3 percent at the end of December. In both cases, CBOE led all twelve options markets by a margin of several percentage points.

We are pleased, but never complacent, with our overall performance in the equity options marketplace. We closely monitor the daily changes in this very fluid arena and are prepared to quickly modify our CBOE and C2 models in response to competitive pressures.

Clearly, we see considerable opportunities on the options landscape and in the volatility space going forward. We continue to capitalize on the favorable operating leverage inherent in our business through disciplined expense management and prudent allocation of capital, while seeding our company’s future growth with programs aimed at developing new products, expanding our user base, and optimizing our market share in commoditized products. On that note, I will turn it over to Alan Dean to report on our financials.

Alan Dean

Thanks Ed and good morning everyone.

I am pleased to report that CBOE Holdings is off to a strong start this year, posting record revenue and earnings per share for the first quarter, driven by growth in trading volume and disciplined control of operating expenses.

Let me start with a recap of our first quarter results. We delivered operating revenue of $157.9 million, up 11 percent compared with last year's first quarter. Adjusted operating income was

$84.6 million, representing an adjusted operating margin of 53.6 percent - a 270 basis point improvement over the first quarter last year. Adjusted net income allocated to common stockholders was $50.0 million, up 14 percent compared with the first quarter of 2013, resulting in adjusted diluted earnings per share of $0.58, a 16 percent increase versus $0.50 per share for the same period last year.

Before I continue, let me point out that our GAAP results reported for the first quarter of 2014 and 2013 include certain unusual items that impact the comparison of our operating performance. These items are detailed in our non-GAAP information provided in the press release and in the appendix of our slide deck.

Turning to the details of the quarter, as shown on this chart, the growth in operating revenue was primarily driven by higher revenue from transaction fees and market data fees.

Transaction fees increased $13.7 million, or 14 percent, compared with the first quarter of last year due to a 31 percent increase in trading volume, offset slightly by a 13 percent decrease in the average revenue per contract (or RPC) versus last year's first quarter. The growth in trading volume was driven by volume gains across each of our product categories with trading volume from equity options up 37 percent, exchange-traded products up 38 percent, index options up 18 percent and futures contracts up 34 percent.

Our blended RPC, including options and futures, declined to 32.9 cents from 37.8 cents in last year's first quarter. The decline was primarily due to an increase in volume-based incentives in the first quarter of 2014 for certain multiply-listed options traded at CBOE under our volume incentive program, reflecting the impact of fee changes implemented in February and March of 2013. In addition, the product mix shifted and lower-margin, multiply-listed options accounted for a higher percentage of trading volume during the quarter compared with the first quarter of 2013.

As a result, the RPC in our options business declined to 28.1 cents compared with 33.3 cents in the first quarter of 2013. The revenue per contract on equity options and exchange-traded products declined by 42 percent and 25 percent, respectively, while the RPC for index options was unchanged year-over-year at 67 cents.

CFE's revenue per contract of $1.62 for the first quarter was relatively unchanged from last year's first quarter.

While multiply-listed options represented a higher percentage of our trading volume during the quarter, the percentage of transaction fee revenue contributed from these contracts fell due to the lower RPC and the strong growth in trading volume from our higher-margin proprietary products.

As depicted on this slide, in the first quarter of this year, multiply-listed options accounted for 65.3 percent of total contracts traded versus 62.1 percent in last year's first quarter. Trading in our highest-margin index options and futures contracts represented 34.7 percent of total contracts traded, down from 37.9 percent in last year's first quarter.

Converting the volume into transaction fees, you see that in the first quarter of 2014 index options and futures contracts accounted for 81 percent of our transaction fees, up from 76 percent in the first quarter of 2013. As Ed noted in his comments, we continue to focus our growth initiatives on our proprietary products that generate the highest return.

Looking at revenue drivers outside of transaction fees, most of our other revenue line items were relatively unchanged this quarter compared with last year's first quarter, with the exception of market data fees. Revenue generated from market data fees increased $1.6 million as a result of higher market data revenue from OPRA, reflecting a higher share of industry transactions and a rate increase for OPRA terminals. CBOE and C2's share of OPRA revenue increased to 24.5 percent from 18.9 percent in last year's first quarter. In addition, we saw

higher revenue from CBOE's streaming markets, reflecting an increase in subscribers as well as rates.

Moving down the income statement to expenses, this next slide details total adjusted operating expense of $73.3 million for the quarter, up $3.2 million or 5 percent, versus last year's first quarter. This increase primarily reflects higher employee costs and royalty fees, offset somewhat by lower expenses for outside services.

Core operating expense of $47.7 million was unchanged compared with the first quarter of 2013. Looking at the details, the key variances were higher employee costs offset by lower expenses for outside services. The increase in employee costs was primarily due to higher salaries resulting from staff additions, mainly in regulatory services, as well as an increase in the provision for incentive compensation, which is aligned with our growth in pre-tax income. The decrease in outside services is due to lower legal expenses.

Overall, through March, core operating expense annualized is tracking in line with our guidance range and we are reaffirming our guidance range for core expenses of $191 million to $196 million for the full year.

Looking at volume based-expenses, royalty fees increased by $2.7 million, or 21 percent. This increase primarily reflects the growth in trading volume in our licensed products, and to some degree, fee adjustments that occurred in conjunction with the extension of our S&P licensing agreement on March 8th of last year.

Our GAAP effective tax rate for the quarter was 39.9 percent versus 38.3 percent in last year's first quarter. The increase in the effective tax rate reflects the recognition of a discrete tax charge in the first quarter of 2014 versus a discrete tax benefit recognized in the first quarter of 2013. The tax charge was primarily due to a change in New York State tax law effective for 2015, changing to market-based sourcing, which impacts our New York State apportionment factor, increasing our deferred tax liability.

Although the effective tax rate exceeds our annual guidance, we see this as a timing issue. Based on what we know now, we still expect the full year tax rate to be in line with our guidance of 38.5 to 39.5 percent.

Taking a look at the balance sheet, we finished the quarter with cash and cash equivalents of $199.1 million, compared to $221.3 million at the end of December.

Our solid financial performance along with a strong balance sheet has allowed us to return a substantial amount of capital to stockholders in the form of share repurchases and dividends.

For the first quarter of this year, we have generated approximately $88 million in cash from operations, paid out nearly $16 million in regular dividends and $44 million in a special dividend, used about $12 million for capital expenditures and another $39 million to purchase stock.

Under our share repurchase plan, we repurchased over 700,000 shares in the first quarter at a total cost of $37 million and an average price of $52.99 per share. Since the inception of our plan, we have used over $179 million to repurchase 5.3 million shares at an average price of $33.55. At quarter end, we had $120.8 million available under our current share repurchase authorizations.

We remain committed to using our cash flow to optimize stockholder value by reinvesting in our business and returning excess cash to stockholders through consistent and sustainable dividends and share repurchases.

We will continue to be disciplined in our repurchase activity, which will vary based upon stock price and other factors.

In closing, our first quarter results demonstrated continued financial and operational discipline and execution, marking the sixth consecutive quarter of year-over-year growth in adjusted operating revenue and adjusted diluted earnings per share.

We are very pleased with our strong start to 2014 and believe we are well positioned for continued growth as we execute on our strategic plan.

This presentation may contain forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are those statements that reflect our expectations, assumptions or projections about the future and involve a number of risks and uncertainties. These statements are only predictions based on our current expectations and projections about future events. There are important factors that could cause actual results to differ materially from that expressed or implied by the forward-looking statements, including: the loss of our right to exclusively list certain index option products; increasing price competition in our industry; compliance with legal and regulatory obligations and obligations under agreements with regulatory agencies; our ability to operate our business, monitor and maintain our systems or program them so that they operate correctly, including in response to increases in trading volume and order transaction traffic; decreases in the amount of trading volumes or a shift in the mix of products traded on our exchanges; legislative or regulatory changes; increasing competition by foreign and domestic entities; economic, political and market conditions; our ability to operate our business without violating the intellectual property rights of others and the costs associated with protecting our intellectual property rights; our ability to maintain access fee revenues; our ability to protect our systems and communication networks from security risks, including cyber-attacks; our ability to attract and retain skilled management and other personnel; our ability to maintain our growth effectively; our dependence on third party service providers; and the ability of our compliance and risk management methods to effectively monitor and manage our risks.

More detailed information about factors that may affect our performance may be found in our filings with the SEC, including in our Annual Report on Form 10-K for the year ended December 31, 2013 and other filings made from time to time with the SEC.