CBOE HOLDINGS, INC.
Second Quarter 2014 Earnings Call - Prepared Remarks
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Debbie Koopman

Good morning and thank you for joining us for our second 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 second 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.

Ed Tilly

Good morning and thank you for joining us today.

Trading activity in the second quarter reflected low market volatility and investor complacency. Overall volume in options and futures at CBOE Holdings averaged 4.8 million contracts per day, down 14 percent from the first quarter and three percent from the second quarter in 2013. Despite the low-volume trading environment, CBOE posted solid financial results and continued to deliver long-term value to our stockholders and market participants. We raised our quarterly dividend, increased our share repurchase authorization and continued to advance our strategic growth initiatives so that CBOE is well positioned to benefit as market conditions improve over time.

Now an update on our strategic initiatives for 2014: leveraging and developing proprietary products, broadening our customer base, and optimizing revenue in commoditized products -- while maintaining the highest standards in market regulation.

Turning first to trading in our SPX and VIX product lines. Second quarter ADV across our SPX complex was down 11 percent sequentially and 13 percent from the second quarter in 2013. ADV in SPX Weeklys, the fastest growing product in that complex, was down 11 percent from the previous quarter, but up 20 percent from the second quarter last year.

VIX options volume declined 21 percent from the previous record-breaking quarter, but rose 11 percent year-over-year. Average daily volume in VIX futures was off 19 percent from the previous quarter, also a record, and eight percent from last year. Low volatility throughout the quarter obviously dampened trading in both SPX and VIX products, but we don't extrapolate when volume is driven by extraordinarily low -- or high -- volatility, nor do these temporary fluctuations inform our strategy. We remain focused on our long-term growth trajectory.

The longer view shows that year to date through June, trading in our SPX complex is down just three percent and trading in SPX Weeklys is up 38 percent from last year's record volume. Year-to-date through June, VIX options trading is up 17 percent and VIX futures are up 10 percent over last year's record pace. In the first quarter, when the VIX Index was relatively low, but not extremely so, we continued to see double-digit growth. And in July, which included days when VIX spiked, VIX options volume increased 15 percent and VIX futures rose 48 percent from the previous year (based on preliminary volume reports). This is more in line with the growth we experienced over the last few years and more of what we would expect going forward.

While current levels of the CBOE Volatility Index tell us the market doesn't expect much risk over the next 30 days, there is far less certainty looking out beyond that 30-day period. It's important to remember that the VIX Index is not simply a measuring stick for risk, but rather represents the cost that investors are willing to pay to hedge that risk, through SPX options. As we look at VIX futures prices over the next three to six months, we see the market expecting a return to more 'normal' levels of volatility. And, as VIX returns to historical norms, we expect to see even greater participation in VIX futures and options trading. Some firms, such as Blackrock and others, are already advising clients to use VIX futures and options in order to hedge against -- or profit from -- potentially rising volatility.

In the meantime, we continue to grow the VIX customer base by leveraging our educational expertise. While second quarter trading conditions were less than stellar, educational opportunities abounded. When volatility is at extremes, be it extremely high or low, media and marketplace attention becomes hyper-focused on VIX, its level, what it means, and why it matters. It is an extraordinary opportunity for CBOE when virtually every financial network, publication and twitter stream is dominated by VIX news and commentary. During such times, the world turns to CBOE for context and meaning. As the "go-to" place for all things related to VIX, CBOE is uniquely positioned to effectively leverage every opportunity to highlight our products and connect with investors -- through thought leadership, educational tools and trading resources, and a robust social media platform that increasingly drives the discussion around volatility and our VIX products.

CBOE's ability to effectively communicate in and with the marketplace is integral to our ability to develop and nurture new product lines. Looking back on the early decades of equity and index options trading, we see that growth in our user base was gaining steam amidst slower trading periods, as investors paused and digested new information about the markets and our products, eventually returning to the market in greater numbers. Four indicators lead us to believe that VIX trading is similarly poised for renewed growth.

First, the demand for VIX futures market data has increased dramatically over the last six months, meaning more firms are positioning to trade VIX futures and to enter the market in a more meaningful way when volatility returns to the marketplace. Second, the mix of market participants continues to shift from banks and traditional floor-based market makers to include proprietary trading firms and CTAs, which tend to view VIX futures as a trading vehicle rather than as a part of an equity derivatives book. This approach tends to generate significantly more volume, particularly in more active markets. Third, despite low levels of volatility, the number of new Trading Permit Holders at CFE continues to increase, portending even greater interest and use of VIX futures going forward. Finally, we are already seeing increased participation and trading opportunities provided by 24-hour trading in VIX futures, which we expect to fuel even further growth as volatility levels revert to historic norms.

We are very encouraged by the early response to our Extended Trading Hours (ETH) initiative in VIX futures. As you may recall, we lengthened the VIX futures trading day by 5 hours and 45 minutes late in 2013 to accommodate the demand for additional trading time domestically, and to enable European-based customers to access trading in their local trading hours. Subsequently, an average of 7.7 percent of VIX futures trading took place in non-U.S. trading hours. On days when overseas events triggered volatility, volume in that period rose as high as 15 percent.

In June, we further extended VIX futures trading to nearly 24 hours to accommodate trading in Asian market hours, as well as a growing worldwide user base. In July, our first full month of 24-hour trading, 10.2 percent of all VIX futures trading took place outside of U.S. trading hours. And, when global events triggered higher volatility, volume in non-U.S. trading hours rose to 20.7 percent. Year-to-date through July, ADV in non-U.S. trading hours rose to 8.1 percent, from 7.7 percent through June.

We are also encouraged to see that trading in the new timeframe is coming from a good mix of customer participation early on, both domestically and internationally, indicating that a broad and diversified user base is accessing VIX futures during extended trading hours.

We look forward to launching extended trading hours for SPX and VIX options later this year. The new ETH session for those products is planned to run from 2:00 a.m. to 8:15 a.m. CT, Monday through Friday. The target start date is the fourth quarter of 2014, pending SEC approval and completion of necessary systems enhancements. CBOE is actively working with Trading Permit Holders and other interested customers to assist them in preparing to participate in extended trading hours for our two most active index options.

Diversifying our VIX product line represents a significant, untapped, opportunity for us to continue to grow volatility trading. Earlier this year we launched futures and options on our new Short-term VIX Index (VXST). Obviously, the recent low-volatility environment has posed significant headwinds for a product of this nature, but we - and many of our customers -- continue to firmly believe in the inherent utility of a short-term VIX product.

We continue to see examples of how Short-term VIX products will be used as investors better understand VXST. In the days following the events in the Ukraine last month, we saw both the Short-term and the VIX Indexes spike, with VXST spiking higher. Not surprisingly, we also saw a corresponding increase in trading as customers used Short-term and regular VIX products, alone or in combination, depending on their market views.

As market participants continue to see how VXST responds to unanticipated market events, as well as to targeted events, such as Fed announcements, the utility of Short-term VIX options and futures becomes clear. To that end, we have launched targeted educational and social media programs to more broadly expose customers to VXST, and how it relates to VIX, so that they better understand it and eventually trade these Short-term VIX products, much as they do our regular VIX products.

We are also preparing to launch our next tradable VIX product in the form of 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, with options to follow. We very much look forward to introducing a VIX futures product that will enable customers to better manage interest-rate risk.

In June 2014, CBOE and C2 accounted for 30.4 percent of all options traded, up nearly a full percentage point from March, when our two options exchanges accounted for a combined market share of 29.5 percent. CBOE increased its industry leading market share by almost half of a percentage point, to 28.4 percent in June from 28.0 percent in March.

CBOE continued to hold the industry's leading market share. In multiply-listed options only, CBOE accounted for 20.7 percent market share, on par with its market share in March of 20.8 percent. CBOE continues to lead all 12 options markets by a margin of several percentage points in both multiply-listed options and total options trading.

Clearly, we see considerable opportunities on the options landscape and in the volatility space going forward. As we begin the month of August at CBOE, our team is prepping for a busy fall season of marketing and educational initiatives and events. We are particularly looking forward

to our 3rd annual CBOE Risk Management Conference Europe, which will be held September 3rd through the 5th, just outside of Dublin. We have much to share this year with European RMC participants, who are among our most active and sophisticated customers. This year's conference will reflect the increased focus on the performance of the small-cap sector by highlighting our Russell product line, which includes options on the Russell 2000 Index (RUT) and Russell Volatility options and futures (RVX). The conference will also feature strategies for Short-term VIX and VXTYN, as well as, strategies employing our SPX product line.

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 continuing to grow our company through 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.

Although our second quarter results fell below last year's record second quarter, it was a solid quarter, particularly considering the challenging market conditions.

I'll start with a summary of the second quarter. Operating revenue came in at $143.9 million, down 5 percent compared with last year's second quarter. Adjusted operating income was $69.7 million, representing an operating margin of 48.4 percent, a decline of 280 basis points compared with the second quarter of 2013. Adjusted net income allocated to common stockholders was $42.6 million, 9 percent below the second quarter of 2013, resulting in adjusted diluted earnings per share of $0.50, a 7 percent decrease versus $0.54 per share for the same period last year.

Before I continue, let me point out that our GAAP results reported for the second quarter of 2013 included 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. There were no non-GAAP adjustments in the second quarter of this year.

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

Transaction fees decreased $8.2 million, or 8 percent, compared with the second quarter of 2013 reflecting a 4 percent decline in trading volume and a 4 percent decrease in the average revenue per contract (or RPC) versus last year's second quarter. In addition, there was one less trading day this quarter versus last year's second quarter. Trading volume declined year-over year in each product category except equity options, which increased 11 percent, while exchange-traded products declined 17 percent, index options fell 6 percent and futures contracts were down 9 percent.

Our blended RPC, including options and futures, declined to 32.2 cents from 33.4 cents in last year's second quarter. The RPC decline was mainly due to a shift in the volume mix, with lower-margin, multiply-listed options accounting for a higher percentage of trading volume in the quarter versus last year's second quarter. In addition, volume-based incentives increased in the second quarter of 2014, primarily as a result of higher trading volume in equity options that qualified for the volume-based incentives at CBOE. As I mentioned earlier, equity options volume increased 11 percent in the quarter and this category accounts for a greater share of volume-based incentives.

While there are a number of variables that impact our RPC, keep in mind that all of the volume tiers used in determining volume-based incentives are based on relative volume thresholds

reached each month versus nominal contracts per month, which was used in prior years. This methodology tends to curtail the changes in RPC, either up or down, as trading volume changes.

Overall, the RPC in our options business declined to 27.5 cents compared with 28.9 cents in the second quarter of 2013. The revenue per contract on equity options and exchange-traded products declined by 13 percent and 6 percent, respectively, while the RPC for index options was relatively unchanged year-over-year at 67 cents.

Conversely, revenue per contract at CFE, our futures exchange, increased 6 percent to $1.64 from $1.54 in last year's second 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.

As depicted on this slide, in the second quarter, multiply-listed options accounted for 66.1 percent of total contracts traded versus 65.3 percent in the second quarter of 2013. Trading in our highest-margin index options and futures contracts represented 33.9 percent of total contracts traded, down from 34.7 percent in last year's second quarter.

Converting the volume into transaction fees, you see that in the second quarter of 2014 index options and futures contracts accounted for 81 percent of our transaction fees, up slightly from 80 percent in the second quarter of 2013.

The lower trading volume industrywide also impacted our regulatory fees, which declined by $0.7 million. As we have told you, our goal is to align the revenue we collect from regulatory fees with our regulatory expenses. Based on our year-to-date revenue collected and expenses, we are reducing the rate per contract assessed for CBOE and C2's options regulatory fees, effective today. Consequently, we expect regulatory fees to decline in the third and fourth quarters compared with the second quarter of this year. To give you some context, assuming industry-wide customer volume is the same in the third and fourth quarters of this year as it was in the second quarter, regulatory fees would go down by about $0.5 million in each of those quarters.

On the plus side, revenue generated from market data fees increased $2.1 million as a result of higher market data revenue from both OPRA and CBOE's market data services. The increase in revenue from OPRA resulted from an increase in CBOE's share of industry transactions. CBOE and C2's share of OPRA revenue increased to 24.4 percent from 20.9 percent in last year's second quarter. The increase in revenue from CBOE's market data services was primarily due to an increase in subscribers.

Moving down the income statement to expenses, this next slide details total adjusted operating expense of $74.2 million for the quarter, up $0.6 million, or 1 percent, versus last year's second quarter. This increase primarily reflects higher expenses for depreciation and amortization, facilities costs and other expenses, partially offset by lower costs for outside services. The higher depreciation and amortization expense is directly related to our increased capital spending this year, which I will touch on later.

Core operating expense of $48.5 million was down $1.1 million, or 2 percent, compared with the second quarter of 2013. Looking at the details, the key drivers were lower expenses for outside services, offset somewhat by higher expenses for facilities costs and other expenses. The year-over-year decrease in outside services was primarily due to lower legal expenses.

In light of the uncertain market conditions, we are in the process of scrutinizing all expenses, as we always do when we see lackluster trading volume over a prolonged period. Based on our expected cost reductions and year-to-date results, we are lowering our guidance for core expenses to a range of $186 million to $190 million. While disciplined cost management is very

much a part of our culture, we push even harder to gain operating efficiencies when trading volume languishes.

Looking at volume based-expenses, royalty fees increased by $0.2 million, or 1 percent. While the key driver of royalty fees is the trading volume in our licensed products, it also includes fees related to certain order flow for multiply-listed options directed to CBOE and fees associated with our market data sales. Higher fees associated with these two items accounted for the increase in royalty fees.

Our GAAP effective tax rate for the quarter was 38.1 percent versus 38.4 percent in last year's second quarter. This brings our cumulative effective tax rate to 39.0 percent through June, which is in line with our guidance. 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 $145.1 million, compared to $191.1 million at the end of March and $221.3 million at the end of December. The decrease in cash primarily reflects cash used to repurchase shares and tax payments made during the quarter.

In terms of capital allocation, our track record of solid earnings and strong cash flow generation allows us to both invest in our business and increase our cash returned to shareholders.

Through the first six months of this year we have used $31 million to pay regular dividends, nearly $44 million for a special dividend payment and another $97 million to purchase our stock.

Capital expenditures through June were $28 million, more than double our spending through June of 2013. This increase accounts for the higher depreciation and amortization expense I mentioned earlier. To date, capital expenditures are in line with our guidance range of $47.0 to $50.0 million for the full year, so we are reaffirming our guidance.

During the second quarter of 2014, we repurchased over one million shares of common stock under our share repurchase program at an average price of $50.57 per share, totaling $51.1 million. Since the inception of our plan through June 30, we used over $230 million to repurchase nearly 6.4 million shares at an average price of $36.26. At quarter end, we had $69.7 million available based on our share repurchase authorizations at that time.

Our capital allocation continues to be disciplined and balanced. We were pleased to announce that the Board increased our quarterly dividend rate by 17 percent to $0.21 per share from $0.18 per share, effective with the third quarter dividend payment. This increase is our fourth consecutive since we instituted a dividend payment in September 2010, following our IPO. Since that time, we have more than doubled our quarterly dividend.

The Board also increased the share repurchase authorization by $100 million. We plan to continue to return cash through our share repurchase program. Taking into account this most recent increase and buyback activity through July 30, we have approximately $150 million available under our share repurchase authorization. These initiatives underscore our efforts to maximize value for our shareholders.

In closing, we will continue to focus on being well positioned to take advantage of more favorable market conditions, while being nimble enough to adapt during lower volume periods. We remain very optimistic about our long-term growth prospects and believe we are well positioned to generate even stronger financial results as market conditions improve and trading volume picks up.

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 options and futures products; increasing price competition in our industry; compliance with legal and regulatory obligations and obligations under agreements with regulatory agencies; decreases in the amount of trading volumes or a shift in the mix of products traded on our exchanges; 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; legislative or regulatory changes; increasing competition by foreign and domestic entities; 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; economic, political and market conditions; 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.