CBOE HOLDINGS, INC.
Third Quarter 2014 Earnings Call - Prepared Remarks
October 31, 2014

Debbie Koopman

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

I am pleased to report that CBOE posted solid financial results for the third quarter and continued to deliver long-term value to our stockholders and market participants. Trading volume for the quarter in options and futures at CBOE Holdings averaged nearly five million contracts per day, up 2 percent from the previous quarter and 7 percent from the third quarter in 2013.

We subsequently saw a significant uptick in October when volume in futures and options at CBOE Holdings surpassed 7 million contracts daily through the 29th, an increase of 40 percent over the year-to-date average daily volume of 5.13 million contracts through September. I'll circle back to October's increases momentarily.

Volatility remained relatively low in the third quarter, but with intermittent spikes as the quarter progressed. We saw CBOE Volatility Index (VIX) options volume increase 6 percent year-over-year and decrease 10 percent from the previous quarter. Average daily volume in VIX futures rose 35 percent from the third quarter last year and 19 percent from the previous quarter.

Average daily volume across our S&P 500 Index option complex was up 8 percent sequentially and 10 percent from the third quarter in 2013. ADV in SPX Weeklys, the fastest growing product in that complex, was up 24 percent from the previous quarter and 54 percent year over year.

In last quarter's call we noted four indicators that trading in VIX futures appeared to be poised for invigorated growth as volatility returned to the marketplace: an increased demand for VIX futures market data, a shift in customer mix toward more active participants, an increased number of new Trading Permit Holders at CFE, and increased participation afforded by 24-hour trading in VIX futures.

In October, as higher volatility returned to the marketplace, trading volume soared in index options and futures, including our VIX, SPX and Russell suite of products. VIX futures average daily volume through October 29th jumped to over 339,000 contracts, up 89 percent month-over-month and 86 percent year-over-year, setting new monthly, weekly and single-day highs. October to date VIX options volume increased 62 percent from the previous month and 22 percent from October 2013. Year-to-date through October 29th, VIX options trading is up 14 percent and VIX futures are up 25 percent over last year's record pace. Additionally, trading in options on the Russell 2000 index rose 36 percent year-over-year and 49 percent sequentially in October.

SPX options volume in October increased 44 percent year-over-year, while SPX Weeklys volume grew 49 percent. Year to date through October, trading in our SPX complex is up 6 percent and trading in SPX Weeklys is up 39 percent from last year's record pace.

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.

In order to cultivate a growing worldwide user base, we extended trading in VIX futures in June to nearly 24 hours. Over 9 percent of all VIX futures trading now take place outside of regular U.S trading hours. On particularly volatile days, we've seen that percentage rise above 20 percent, a reminder that in the midst of economic or political uncertainty, the global marketplace turns to CBOE to trade volatility.

Looking ahead, we plan to extend trading hours for SPX and VIX options in the first quarter of 2015. Although we intended to launch those initiatives by the end of this year, additional time was required to complete the regulatory approval process. The new trading session for SPX and VIX options will run from 2:00 a.m. to 8:15 a.m. CT, Monday through Friday.

Diversifying our Volatility Index product line represents a significant opportunity to expand trading in the CBOE marketplace. I'm happy to report that we're less than two weeks out from launching our next tradable VIX product, futures on the CBOE/CBOT 10-Year U.S. Treasury Note Volatility Index.

VXTYN, the first index to measure the volatility of U.S. government debt, applies CBOE's VIX Index methodology to futures options data from CME Group's 10-year U.S. Treasury note contract, the most actively traded U.S. Treasury futures. VXTYN futures will enable market

participants for the first time to target and manage interest rate volatility with the efficiency afforded by a single product.

In preparing for the launch, we have worked closely with - and received encouraging feedback from - market participants most likely to trade VXTYN futures. These include mortgage-backed securities investors and other large credit managers; bond funds; hedge funds; volatility arbitrage firms and global macro participants looking to act on upcoming monetary policy announcements or to capture pricing anomalies between fixed-income and equity volatility.

We are also encouraged by the interest we're seeing among ETP issuers, as well as from European and Asian customers who have exposure to U.S. rates, either directly or indirectly.

We view the launch of VXTYN futures as the beginning of a significant and ongoing opportunity to grow Volatility Index trading. The market for interest rate derivatives, by far the largest OTC asset class, is estimated to be 40 times the size of the equity market in terms of notional value outstanding. While I would caution that making inroads in this new market will take time and an ongoing educational push, we are thrilled to begin the journey, which we expect will lead to additional avenues for VIX product development going forward.

Moving on now to market share: in September 2014, CBOE and C2 accounted for 29.1 percent of all options traded, down from 30.4 percent in June.

CBOE continues to lead all 12 options markets by a margin of several percentage points in both multiply-listed options and total options trading, accounting for 27.0 percent of total options traded in September, versus 28.4 percent in June. In multiply-listed options only, CBOE's market share was 20.5 percent in September, down slightly from 20.7 percent in June.

As announced in the third quarter, we are in discussions with the Financial Industry Regulatory Authority on a potential agreement for FINRA to provide regulatory services to CBOE and C2. FINRA currently provides regulatory services to 10 of the 12 options markets.

If CBOE and FINRA reach a final agreement, and subject to regulatory review, it is expected that most of our Regulatory Services Division and certain support staff would transition to FINRA. CBOE would maintain an in-house Regulatory team, which would work closely with FINRA in an oversight role.

Importantly, CBOE and C2 would continue to operate as SROs and to work closely with the SEC. We would remain committed to providing the highest standards in market regulation. In fact, we believe that FINRA's independence and regulatory efficiency together with CBOE's regulatory oversight experience and options expertise could further strengthen the integrity of our markets and investor protection.

The potential agreement with FINRA is not expected to have a material impact on CBOE's financial results, given that our regulatory expenses are generally offset by regulatory fees. Discussions are ongoing. We expect terms could potentially be finalized within the next few months.

As we close in on the end of 2014, we remain focused on the strategic growth initiatives we laid out at the beginning of the year. Our team's disciplined and consistent execution of that

strategy, despite less favorable trading conditions earlier this year, paved the way for CBOE's continued success when market conditions inevitably changed, as they did most notably this past month. While we were pleased to begin the final quarter on October's high note, we are focused on the opportunities that lie ahead for the remainder of 2014 and beyond. With that, I will turn it over to Alan Dean.

Alan Dean

Thanks Ed and good morning everyone.

CBOE's third quarter results demonstrated strong financial performance both year-over-year and sequentially.

I'll start with a summary of the quarterly results. Operating revenue came in at $148.9 million, 9 percent ahead of last year's third quarter. Operating income was $75.1 million, representing an operating margin of 50.4 percent, up 40 basis points compared with the third quarter of 2013. Net income allocated to common stockholders was $48.1 million, an increase of 17 percent versus the third quarter of 2013, resulting in diluted earnings per share of $0.57, a 21 percent increase compared with $0.47 per share for the same period last year.

There were no non-GAAP adjustments in the third quarter of this year or last year, so all the numbers I will be referencing are on a GAAP basis.

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

Transaction fees increased $11.3 million, or 12 percent, compared with the third quarter of 2013 reflecting a 7 percent increase in trading volume and a 4 percent increase in the average revenue per contract (or RPC) versus last year's third quarter. Trading volume increased year-over-year in each product category - equity options increased 5 percent, options on exchange-traded products were up 8 percent, index options increased 7 percent and our highest RPC products, futures contracts, were up 34 percent.

Our blended RPC, including options and futures, increased to 32.9 cents from 31.5 cents in last year's third quarter. The RPC increase was mainly due to a shift in the volume mix, with higher-margin, index options and futures contracts accounting for a higher percentage of trading volume in the quarter versus last year's third quarter. In addition, the RPC for index options and futures contracts increased due to price adjustments made at the beginning of the year and the mix of volume by account type within each of these product categories.

Overall, the RPC in our options business increased to 27.5 cents compared with 27.3 cents in the third quarter of 2013 and was unchanged from the second quarter of this year. On a year-over-year comparison, the revenue per contract was up 2 percent for index options, unchanged for equity options and declined by 7 percent for options on exchange-traded products.

Revenue per contract at CFE, our futures exchange, increased 4 percent to $1.63 from $1.56 in last year's third quarter.

As depicted on this slide, in the third quarter, trading in our highest-margin index options and futures contracts represented 33.8 percent of total contracts traded, up from 33.1 percent in last year's third quarter. The difference represents trading in multiply-listed options, which accounted for 66.2 percent of total contracts traded versus 66.9 percent in the third quarter of 2013.

Converting the volume into transaction fees, you see that in the third quarter of 2014 index options and futures contracts accounted for 81 percent of our transaction fees, up from 79 percent in the third quarter of 2013.

Revenue generated from market data fees increased by $1.1 million as a result of higher revenue from CBOE's market data services, primarily resulting from an increase in subscribers and rate adjustments.

Market data revenue from OPRA was flat year-over-year. While CBOE and C2's share of OPRA revenue increased to 24.7 percent from 23.6 percent in last year's third quarter, the revenue distributable from OPRA was down because last year's third quarter included a one-time entrance fee from a new exchange.

Regulatory fees for the quarter were relatively even with last year's third quarter but down about $0.8 million compared with the second quarter. As we told you on our prior earnings call, effective August 1, we reduced the rate per contract assessed for CBOE and C2's option regulatory fees in an effort to align the revenue we collect from regulatory fees with our regulatory expenses for the year. As a result, option regulatory fees declined sequentially. In addition, other fees related to regulatory services were down compared to the prior quarter, primarily due to an accrual adjustment.

Moving down the income statement to expenses, this next slide details total operating expense of $73.8 million for the quarter, up $5.5 million, or 8 percent, versus last year's third quarter. This increase primarily reflects higher expenses for depreciation and amortization, royalty fees and employee costs. The higher depreciation and amortization expense is directly related to our increased capital spending this year, which I will come back to later.

Core operating expense of $46.3 million increased by $1.5 million, or 3 percent, compared with the third quarter of 2013, primarily driven by higher expenses for employee costs and outside services.

The increase in employee costs reflects an increase in salaries resulting from annual salary adjustments, as well as increases in severance expense and the provision for incentive compensation, offset somewhat by a reduction in stock-based compensation.

As we communicated on our second quarter earnings call, we took measures during the third quarter to trim expenses for the remainder of the year, which we generally do when we see lackluster trading volume over a prolonged period. In early September, we provided some additional color on how we expected our cost savings to line up between the third and fourth quarter, stating that we expected core expenses in the fourth quarter to be about $1.5 to $2.5 million lower than third quarter core expenses. As it turns out, we now estimate that the

difference will be around a $1 million, which would put us at the mid-point of our guidance range for core expenses of $186 to $190 million for the year.

Looking at volume based-expenses, royalty fees increased by $2.2 million, or 14 percent. The increase was primarily due to higher trading volume in licensed products, which include index options and VIX futures. In addition, royalty fees included higher fees associated with our market data sales and fees linked to certain order flow for multiply-listed options contracts directed to CBOE.

Our GAAP effective tax rate for the quarter was 35.4 percent versus 39.1 percent in last year's third quarter. The lower tax rate for the quarter reflects changes in our tax provision primarily resulting from adjustments to our state tax provision versus prior estimates.

Our cumulative effective tax rate through September is 37.8 percent, which is below our full-year guidance of 38.5 to 39.5 percent. We now expect our tax rate for the full year to be slightly below the low end of our guidance range.

Turning to the balance sheet, we finished the quarter with cash and cash equivalents of $127 million, compared to $145 million at the end of June and $221 million at the end of December. The decrease in cash quarter-over-quarter primarily reflects cash used for share repurchases, dividend payments and tax payments made during the quarter.

Our business continues to generate a significant amount of cash. Year-to-date, we've generated net cash flows from operating activities of over $184 million versus $172 million in the same period last year. More importantly, we remain disciplined in how we use this cash. We also have a strong track record of returning available cash to our shareholders in the form of dividends and share buybacks. Through the first nine months of this year we have used $49 million to pay regular dividends, nearly $44 million for a special dividend payment and another $148 million to purchase our stock.

Capital expenditures through September were $40 million, double our spending through the same period in 2013, as we continue to invest in hardening and enhancing our systems. This increase accounts for the higher depreciation and amortization expense I mentioned earlier. We expect our capital expenditures in the fourth quarter to result in spending that is in line with our guidance of $47.0 to $50.0 million for the full year, so we are reaffirming our guidance.

During the third quarter of 2014, we repurchased over one million shares of common stock under our share repurchase program at an average price of $50.64 per share, totaling $51.3 million. Since the inception of our plan through September 30, we used over $282 million to repurchase nearly 7.4 million shares at an average price of $38.24, representing an 8 percent reduction in outstanding shares.

At September 30, we had approximately $118 million available under our share repurchase authorization.

When you consider the growth opportunities we believe we have and the cash we return to our investors, we believe our company is set up to provide a compelling total shareholder return over the long run.

With that, I will turn the call back over to Debbie.

Debbie Koopman

At this point, we would be happy to take questions. We ask that you please limit your questions to one per person to allow time to get to everyone. Feel free to get back in the queue and if time permits we'll take a second question.

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.