CBOE HOLDINGS, INC.
Fourth Quarter 2014 Earnings Call - Prepared Remarks
Friday, February 6, 2015

Debbie Koopman, Investor Relations

Good morning and thank you for joining us for our fourth quarter conference call. On the call today, Ed Tilly, our CEO, will discuss the quarter and our strategic initiatives for 2015. Then, Alan Dean, our Executive Vice President and CFO, will detail our fourth quarter 2014 financial results and provide guidance on certain financial metrics for 2015. Following their comments, we will open the call to Q&A. Also joining us for Q&A will be 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, CEO

Good morning and thank you for joining us today.

Strong fourth quarter trading made 2014 a year for the record books at CBOE Holdings. Record trading at each of our exchanges -- CBOE, C2, and CFE -- combined for a total of 1.3 billion options and futures contracts traded, an all-time high and an increase of 12 percent over the previous year's total.

The groundwork laid by our team -- to engage customers, develop products and broaden access to our marketplace - positioned CBOE to increase CBOE Volatility Index® (VIX® Index) futures trading by 26 percent and total options trading by 11 percent, outpacing U.S. options industry growth by several percentage points.

We were particularly gratified to see record trading in our proprietary products, S&P 500 Index (SPX) options and VIX futures and options.

Increased trading across all product lines in 2014 drove new highs in key financial metrics, including revenue, earnings, and operating margin, making 2014 our company's fourth consecutive year of record financial results -- a performance that allowed us to reward shareholders through increased quarterly dividends and share repurchases, and to lay the foundation for ongoing growth in 2015 and beyond.

CBOE continued to lead all 12 options exchanges with a total market share of 28.6 percent in December 2014, an increase of just over one percentage point from December 2013.

I'm pleased to say the momentum has carried into the new year. January average daily volume across all products traded at CBOE Holdings was 5.4 million contracts, an increase of five percent from December 2014. While we continued to see strong trading in VIX futures and SPX

options, we saw a decline in VIX options trading, which we attribute to the unusual flattened VIX curve that we began to see in January,

To give you a better sense of this, we thought we would show you what traders saw looking out at the VIX term structure, first in December, then in January. It's very much a tale of two markets. In December, we see the normal contango we almost always see in the VIX curve -- the upward slope that creates so many trading opportunities.

Fast forward to January, and we see a flattened term structure, which is an anomaly for VIX. This tells us the market is uncertain about both short- and long-term risk. Meaning that many position traders who use VIX options are temporarily on the sidelines. We fully expect the curve to return to its norm, which is contago. And, with the return of contango, a return to the trading opportunities that have been temporarily negated by the abnormal term structure.

Next, I'll take a few moments to discuss our 2015 initiatives, beginning with the opportunity for index options and futures trading overall.

A November 2014 TABB Group study highlighted strong growth in U.S. equity index derivatives over the past five years and projected an additional lift of 6 percent this year. Over 90 percent of asset managers plan to increase use of equity index derivatives in 2015, citing market structure changes in the OTC and cash markets, as well as the inherent utility and versatility of the products themselves.

Much of TABB's report corroborates our own observations and customer feedback. We also look to an ongoing macro shift, from active to passive investments and more transparent index products, as a powerful indicator and driver of continued growth in index trading at CBOE.

Total dollars in passive investments more than tripled between 2004 and 2012, and are expected to triple again between 2012 and 2020, shifting from 11 percent of total assets under management in 2012, to 22 percent by 2020. We expect this to drive increased trading in index options and futures among fund managers who use these products to drive returns and hedge risk.

We believe CBOE is uniquely positioned to benefit from the trends pointing to increased use of equity derivatives. Key to our strategy is expanding and leveraging partnerships with index providers. We were pleased in December to enter into a licensing agreement with MSCI that enables CBOE to be the only U.S. exchange to list options on several well-known MSCI global indexes. We plan this quarter to launch options on the popular MSCI EAFE and MSCI Emerging Markets Indexes, with four others to follow later this year, pending regulatory approval.

The global exposure afforded by MSCI Index products brings a new dimension to our index option franchise, which features options on prominent domestic indexes, including the S&P 500, Russell 2000, Dow Jones, and Nasdaq 100. Our MSCI partnership also provides us with the ability to create MSCI volatility products as a means to similarly bring global exposure to our VIX product line.

In addition to forging partnerships with index owners, we continue to leverage our in-house product expertise to create proprietary index options and futures. The ability to create our own products, such as VIX, puts CBOE on the licensor side of the equation, enabling us to create additional, recurring revenues and extend our customer reach.

As a result of our track record in product innovation and successful collaboration with index provider partners, CBOE not only brings new index products to market, the market brings index product ideas and opportunities to CBOE. This virtuous loop enables us to offer our customers the world's widest array of index option and volatility products and deep, liquid markets in which to trade them.

While product innovation is central to our unique value proposition, we are equally committed to mining the significant untapped opportunity in our current index product mix. In 2014, SPX trading volume increased by eight percent over 2013, led by an increase in SPX Weeklys trading of 38 percent.

It bears mention, given that we are frequently asked about the life cycle of growth in VIX trading, that SPX volume increased at a compound annual growth rate of 16 percent over the last ten years -- a time frame that represents years 21 through 31 in the life of SPX. More important, the aforementioned industry trends point to considerable headroom for increased trading in our flagship product.

We plan to further grow SPX trading in 2015 through intensified educational efforts aimed at institutional investors, including OTC participants, fund managers, and overseas investors.

We've mentioned in the past our ongoing educational efforts with the buy-side, which, despite the inherent leveraging and hedging power of SPX options, has only begun to broadly embrace these products. After chipping away at this market for many years -- sometimes one pension fund at a time - we believe we are nearing an inflection point where increased awareness and understanding of SPX options meets the opportunity created by the ongoing shift from active to passive funds and from OTC to listed equity derivatives trading.

We recently commissioned a white paper on fund use of options, which found that options-based funds have higher risk-adjusted returns and lower volatility. We have received great feedback on the paper from buy-side customers in need of data-driven validation to increase their ability to use equity derivatives to manage funds.

We will continue to expand our SPX marketplace globally in 2015. SPX options provide a means to take a position on the broader U.S. market with a single transaction, an efficiency of particular appeal to overseas investors. This quarter we will enable a global customer base to more conveniently access SPX trading through extended trading hours. As announced this morning, the new SPX trading session will begin on Monday, March 9th, following our launch of extended trading hours in VIX options, beginning March 2nd. The new session for SPX and VIX options will run from 2 a.m. to 8:15 a.m. Chicago time.

Turning now to VIX futures and options. Further growing a thriving VIX product line and marketplace is a major opportunity and priority for us. VIX futures trading established a fifth consecutive record year in 2014 with average daily volume of 201 thousand contracts, an increase of 26 percent over the previous year. VIX options traded more than 632 thousand contracts per day, a new record and an increase of 11 percent.

Diversifying our VIX product line represents a significant means for CBOE to further define and expand the volatility space. On January 13th, we began calculating and disseminating values for three new volatility indexes based on the prices of the most liquid FX options traded at CME: the Dollar/Euro, Dollar/British Pound and Dollar/Japanese Yen futures contracts. The new indexes offer the first ever measures of pure FX volatility, and we look forward to developing tradable products based on them going forward.

While we are excited about new products in the pipeline, we also are committed to developing markets for two important contracts launched last year, Short-term VIX (VXST) futures and options and Interest Rate VIX futures based on the on the CBOE/CBOT 10-Year Treasury Note VIX Volatility Index (VXTYN).

We introduced VXST futures and options last year into what then became sustained headwinds of historically low volatility. Despite a slower-than-expected start, customer feedback confirms an appetite for short-term volatility trading and fuels our belief in the product's potential. We will continue to work closely with end users, presumably under more favorable trading conditions, to evaluate and adjust our approach as necessary.

We view the November launch of VXTYN futures as the beginning of an ongoing opportunity to grow VIX trading, but caution that making inroads in trading is a longer-term proposition. Interest rates represent an entirely new sector of volatility trading -- laying the tracks to reach and educate this new customer base will be an ongoing mission for our team.

We look also to the opportunity to grow VIX trading overseas. After implementing near 24-hour trading in VIX futures last June, more than nine percent of all VIX trading now takes place outside of regular U.S. trading hours. On days where there is breaking market news outside of U.S. trading hours, we've seen that percentage rise to as much as 20 percent. With this quarter's planned roll out of extended trading hours in SPX and VIX options, I am pleased to say that we will provide a growing worldwide customer base with increased access to our three fastest-growing, most-profitable products.

We continue to leverage the efficiencies afforded by marketing a comprehensive index suite that enables market participants to hedge and trade global volatility, the global stock market, the broad U.S. stock market, the U.S. small cap market, and the world's emerging markets. There are obvious synergies in using these products in tandem and significant overlap among our customer segments. We leverage our marketing and educational efforts accordingly.

We were pleased late last year, for instance, to launch a newly enhanced CBOE.com website as well as a new CBOE Mobile App that prominently feature our proprietary products. Both have tremendous reach and both will be further expanded in the coming year.

This year, we will also expand our successful Risk Management Conferences, beyond the U.S. and Europe, with the first RMC in Asia. RMC showcases our premium index products and attracts sophisticated and influential market participants who tend to be early adopters of new CBOE products and services.

Embedded in all of our strategic initiatives are ongoing efforts to ensure that our systems are efficient, robust and secure. I'm pleased to say we completed a major systems effort in the fourth quarter by separating CFE's trading environment from CBOE, thereby greatly reducing the potential for any single point of failure in our marketplace. The continued rollout of extended trading hours and the implementation of numerous hardening and performance upgrades are priorities for us in 2015.

Protecting the integrity of our markets is ingrained in all that we do. In December of 2014, we entered into an agreement with the Financial Industry Regulatory Authority (FINRA). Under that agreement, FINRA began to perform the majority of CBOE's and C2's options regulatory services on January 1st. Alan will address the financial implications of the agreement, but I will note here that we believe the combination of FINRA's regulatory independence and efficiency, with CBOE's options regulatory oversight experience, further reinforces the integrity of our markets and investor protection.

I will close here by noting that our record 2014 was the result of the sustained efforts and disciplined approach of our entire team to broaden access to our marketplace, expand our unique product set, and grow our customer base. Our team's ability to consistently advance these three strategic growth initiatives leaves us well positioned to meet the considerable opportunities on the horizon this year and beyond. We couldn't be more excited to build on that momentum. With that, I will turn it over to Alan Dean.

Alan Dean, CFO

Thanks Ed.

Good morning everyone and thank you for joining us.

This morning, I will walk you through our fourth quarter results and then provide guidance on certain financial metrics for 2015.

CBOE Holdings had another strong quarter, benefiting from more favorable market conditions and solid execution from our team.

As outlined in the press release we issued earlier this morning, operating revenue was $166.5 million in the fourth quarter, up 17 percent compared with last year's fourth quarter. Adjusted operating income was $88.8 million, representing an adjusted operating margin of 53.4 percent, up 220 basis points versus the fourth quarter of 2013. Adjusted net income allocated to common stockholders was $53.6 million, an 18 percent increase compared with 2013's fourth quarter, while adjusted diluted earnings per share increased 23 percent to $0.64.

Before I continue, let me point out that our GAAP results reported for the fourth quarter of 2014 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 this slide shows, the growth in operating revenue was primarily driven by higher transaction fees.

Transaction fees increased $23.7 million, or 24 percent, from last year's fourth quarter, due to a 15 percent increase in trading volume and an 8 percent increase in the average revenue per contract (or RPC). Trading volume increased across every product category in the fourth quarter, compared against both the prior year period and the previous quarter.

Our blended RPC, including options and futures, was 34.0 cents compared with 31.6 cents in the fourth quarter of 2013. This increase mainly resulted from a shift in the mix of trading volume towards our highest margin products - index options and VIX futures.

The RPC in our options business increased to 28.4 cents compared with 27.5 cents in last year's fourth quarter. The RPC on equity options and exchange-traded products declined by 9 percent and 16 percent, respectively, while the RPC on index options rose 5 percent. The RPC decline in the multiply-listed products was primarily due to an increase in volume discounts as market participants optimized the benefits offered in our fee schedule through higher levels of trading.

On the futures side, CFE's revenue per contract increased 3 percent to $1.62 from $1.57 in the fourth quarter of 2013, primarily resulting from a more favorable mix of trades by account type, as well as fee changes.

As this slide depicts, the contribution from our highest-margin index options and futures contracts accounted for 35.3 percent of total volume in the fourth quarter versus 33.8 percent in 2013's fourth quarter.

Converting the volume into transaction fees, you see that index options and futures contracts accounted for 83.7 percent of transaction fees, up from 80.1 percent in the fourth quarter of 2013.

Now let me provide a few brief comments on some other revenue variables that influenced the quarter. Access fees were down about 5 percent compared with last year's fourth quarter, primarily due to a decline in market maker permits. Looking ahead, we expect to see a similar decline for the full-year 2015 and are projecting access fees to be down by about $3.0 to $3.5 million this year versus 2014.

Regulatory fees for the quarter increased $1.0 million compared with 2013's fourth quarter, reflecting a higher rate for the options regulatory fee, as well as an increase in industry-wide customer trading volume. As we have pointed out in prior earnings calls, the revenue derived from these fees is only available to cover expenses we incur to carry out our obligations as a regulator. As a result, we make adjustments as needed to keep the revenue obtained from the options regulatory fee and related expenses in balance.

For 2015, we expect regulatory fees to go down by about $2.0 to $2.5 million due to the elimination of fees related to CBSX, our stock exchange which ceased trading in 2014, and a lower ORF rate compared to 2014.

Now let me turn to expenses. This slide details total adjusted operating expense of $77.7 million for the quarter, an increase of $8.5 million or 12 percent, compared with last year's fourth quarter. Adjusted expenses for the fourth quarter of 2014 exclude $1.9 million of severance expense, which relates to the outsourcing of the majority of our regulatory services to FINRA.

Turning to core operating expense, this slide details fourth quarter core expense of $46.5 million. This represents an increase of $2.6 million or 6 percent, compared with the fourth quarter of 2013, primarily due to higher expenses for outside services.

The increase in outside services was mainly due to higher costs for legal expenses and contract services. The increase in legal expenses reflects the recognition of an insurance reimbursement in the fourth quarter of 2013, with no corresponding benefit this year.

Volume-based expenses, which include royalty fees and trading volume incentives, were $20.2 million for the quarter, an increase of $3.9 million, or 24 percent, primarily reflecting a $4.2 million increase in royalty fees. The increase was mostly 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 contracts directed to CBOE.

Effective for 2015, we are making some adjustments to royalty fees to improve its alignment with the trading volume of licensed products. Going forward, the fees linked to order flow will be reported as contra-revenue, offset against transaction fees. This change should result in a more consistent metric for modeling royalty fees and better align the trading volume for licensed products with royalty fees. Taking these reclassifications into account, we expect the royalty fee rate per licensed contract traded to be just under $0.15 for the year, reflecting a rate of about $0.14 for the first quarter and $0.15 in subsequent quarters in 2015. Volume from all index options contracts traded, VIX futures and any other licensed contracts should be taken into account for this expense projection.

Our GAAP effective tax rate for the quarter was 41.2 percent versus 36.1 percent in last year's fourth quarter. The increase in the effective tax rate for the quarter was primarily due to tax adjustments related to changes in our assessment of uncertain tax positions and a lower benefit from discrete items versus the prior-year quarter. Excluding the tax adjustment related to a prior period, which is included in our non-GAAP adjustments, the effective tax rate was 39.4 percent compared with 36.1 percent for the fourth quarter of 2013.

Let's turn now to a few highlights relating to our balance sheet and capital allocation. In 2014, we generated more than $263 million in cash from operating activities, which enabled us to return more than $67 million to stockholders through regular dividends, $44 million through a special dividend and more than $177 million through share repurchases. Through share repurchases, we reduced shares outstanding by 3 percent in 2014. Since our share repurchase program was implemented in August of 2011, we have reduced our shares outstanding by 6 percent.

Our capital position remains strong, ending 2014 with cash and cash equivalents of $148 million. Our approach to capital allocation remains unchanged, we look first to fund the growth of our business, then to return capital to our stockholders through sustainable quarterly dividends and share repurchases.

At December 31, we had $90 million remaining on our share repurchase authorizations. We consider both dividends and share repurchases important in providing additional value to our stockholders.

A few days ago, we announced that we declared a dividend of $0.21 per share for the first quarter of 2015.

Now I will provide some guidance for you to consider as you refine your models for 2015.

Looking at core expenses for the full-year 2014, we came in at about $189 million, in line with our guidance range of $186 to $190 million, which we provided back in August.

For 2015, we expect core expenses to be in a range of $195 million to $199 million, an increase of 3 to 5 percent versus 2014. This increase primarily reflects higher expenses for data processing, business development, which is included in travel and promotional expense, and outside services. In addition, we expect a reduction in employee costs as a result of our regulatory services agreement with FINRA.

As Ed noted, CBOE and C2 entered into an agreement with FINRA to perform the majority of the exchanges' regulatory services. As part of this agreement, many employees of CBOE and C2 transitioned to FINRA in late December. As a result, in 2015 you will see our employee costs decrease and outside services increase. Our core expense guidance anticipates a net reduction in employee costs of approximately 8 percent, or $10 million, and a net increase in expenses related to outside services of 45 percent, or about $14 million. While there are other variables impacting these line items, the FINRA agreement is the most material.

The net decrease in employee costs for 2015 represents staff reductions resulting from the FINRA agreement net of increases for staff additions, merit increases and incentive compensation. Adjusting for the impact of the FINRA agreement, employee costs would increase and outside services would be relatively unchanged in 2015 compared with 2014.

Under our agreement, FINRA will utilize CBOE's regulatory software over a transition period. As a result, we are accelerating the depreciation of certain regulatory software to be fully-depreciated at the end of this period, which will add about $3 million to depreciation and amortization expense in 2015.

Continuing stock-based compensation, which is included in core expenses, is expected to be about $12 million for the year. The decrease versus 2014 is due to the final vesting in June of 2014 of stock awards granted in 2010 following our IPO, offset somewhat by new grants awarded.

Depreciation and amortization expense is expected to be between $46 to $48 million, reflecting the capital additions in 2014 and the accelerated deprecation for regulatory software I referenced earlier.

In 2015, capital spending is expected to be between $37 to $40 million, down somewhat compared with the $50 million we spent in 2014. The heightened level of spending in 2014 supported our efforts to harden our systems. In 2015, the majority of our capital will continue to be used to enhance the efficiency and integrity of our trading systems.

Finally, our effective tax rate is projected to be between 38.5 percent and 39.5 percent for 2015.

In closing, 2014 was a great year and we enter 2015 well-positioned to continue to deliver solid results, while also continuing to invest for long-term growth. I am very optimistic about the opportunities before us and look forward to updating you on our progress throughout the year.

Thank you for your interest in CBOE. I will now turn it back to Debbie so we can take your questions.

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 and trade 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; the accuracy of our estimates and expectations; legislative or regulatory changes, including heightened capital requirements for some of our customers; 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 accommodate trading volume and order transaction traffic without failure or degradation of performance of our systems; our ability to protect our systems and communication networks from security risks, including cyber-attacks; economic, political and market conditions; our ability to maintain access fee revenues; our ability to meet our compliance obligations; 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.