CBOE HOLDINGS, INC.
Second Quarter 2016 Earnings Call - Prepared Remarks
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Good morning and thank you for joining us for our second quarter 2016 earnings conference call. On the call today, Ed Tilly, our CEO, will provide an update on our strategic initiatives for 2016. Then, Alan Dean, our Executive Vice President and CFO, will review our second quarter 2016 financial results. Following their comments, we will open the call to Q&A. Also joining us for Q&A are Ed Provost, President and COO, and John Deters, Chief Strategy Officer and Head of Corporate Initiatives.

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.

Edward Tilly, CEO

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

Good morning and thank you for joining us today.

I am pleased to report another strong quarter for CBOE Holdings with increases in revenue and adjusted diluted earnings per share of 10% and 11%, respectively. Our second quarter financial results were fueled by the ongoing growth of trading in our proprietary index products, led by near record trading in VIX futures. It was the fourth consecutive quarter in which trading in our proprietary products exceeded 40 percent of our overall trading volume. Average daily volume in futures and index options trading rose 20 percent year-over-year in the second quarter, significantly outpacing the year-over-year increase of 2 percent for multiply-listed options traded industrywide.

Throughout the quarter we also made significant progress in our four-point growth strategy: to develop unique products, expand our customer base, leverage strategic alliances, and define and lead the options and volatility space globally.

Our strong financial results were largely fueled by spikes in trading in futures and options on the CBOE Volatility Index (VIX) and options on the S&P 500® Index (SPX). The VIX Index and SPX are widely viewed as proxies for worldwide volatility and the global stock market, respectively. Investors worldwide turned to CBOE's marketplace in the face of increased market uncertainty leading up to, and in the aftermath of, the Brexit vote. Although the referendum was a European versus a U.S. market event, traders were able to hedge their global equity exposures using VIX futures, in real time, hours before European markets opened for trading. VIX futures were available to traders during Asian, European and U.S. market hours, and remained open as stock markets around the world reacted.

Reaction to the referendum was vividly seen in non-U.S. trading hours on June 24th as it became increasingly clear that Great Britain had voted to leave the European Union. CBOE's 24-hour VIX futures marketplace functioned as expected with trading in our overnight session soaring to record levels. An excess of 235,000 contracts changed hands in non-U.S. hours, surpassing the previous single-day record set on August 24, 2015 by 67 percent.

Strong VIX futures trading carried into regular U.S. trading hours as well. Overall, average daily volume in VIX futures reached 258,000 contracts, an increase of 41 percent over the second quarter last year and 19 percent over the prior quarter. Average daily volume in VIX options trading rose 17 percent over the second quarter 2015 and declined 8 percent from a very strong first quarter 2016.

It is worth noting that last year we added an overnight trading session in VIX and SPX options -- from 2:00 a.m. to 8:15 a.m. central time -- and began dissemination of the spot VIX Index during that same timeframe. In addition to increased trading hours, we believe that access to real-time volatility information during regular European trading hours further elevated VIX and SPX trading among overseas investors as the Brexit news unfolded.

We also continued to see increased trading in VIX Weeklys futures and options, which launched last July and August, respectively. Second quarter average daily volume in VIX Weeklys increased 30 percent over the previous quarter. We attribute the ongoing growth in VIX Weeklys trading to the trading precision these products provide in response to breaking news and in anticipation of economic policy announcements.

The global shock waves kicked off by the Brexit referendum were also reflected in heavy trading in SPX options, which enable investors to efficiently hedge the market with a single transaction. For the month of June, SPX options volume averaged 1.2 million contracts daily, just shy of the all-time monthly record of 1.3 million contracts set in August 2015. For the quarter, average daily volume in SPX options rose 19 percent from the second quarter last year and decreased 5 percent from the previous quarter. July to date, SPX options have traded over one million contracts per day, about 9% ahead of the second quarter.

Strong Weeklys trading also continued to drive volume in our SPX marketplace. SPX Weeklys trading increased 18 percent over last year's second quarter and 7 percent over the previous quarter, fueled in part by the growth of Wednesday Weeklys. Our Wednesday-expiring product, launched in February, complements standard SPX Weeklys, which feature end-of-week expirations. Pending regulatory approval, we plan on August 15 to add Monday-expiring SPX Weeklys, which will allow investors to hedge their over-the-weekend risks. We expect the addition of a third expiration alternative to further increase SPX Weeklys trading and to provide customers with additional trading precision and flexibility.

We expect the results of the Brexit referendum to continue to play out across markets in the months to come, as will other macro geo-political events domestically and abroad. Regardless of how or when market events unfold, our focus remains on systematically expanding our global customer base through targeted initiatives in education, business development and trading technology.

We continue to leverage the efficiencies afforded by a comprehensive suite of index and volatility products through educational programs aimed at helping investors understand the utility of our product line in any market conditions. We are fast approaching our fifth annual CBOE Risk Management Conference in Europe, which is scheduled to take place September 26th through 28th in County Wicklow, Ireland. And, I'm pleased to say after many years of concentrated business development efforts in Europe, we opened our London office earlier this month.

As mentioned, the implementation of extended trading hours in SPX options and VIX options and futures, as well as the overnight dissemination of VIX Index values, helped facilitate trading in these products when global investors most needed them to manage market uncertainty and turmoil. Both were major trading technology initiatives that significantly extended our customer reach and brought new efficiencies to trading our VIX and SPX product lines globally. Similarly, by establishing connectivity earlier this year between CFE and Stellar Trading Systems, a major vendor in Europe and Asia, new customers were connected to our marketplace ahead of June's volatility.

We continue to pave the way for future growth through strategic partnerships aimed at responding to emerging challenges and opportunities in the marketplace, including new trends in global regulatory reform.

In May, CBOE Holdings made a minority equity investment in the Eris Exchange, a U.S-based futures exchange that offers swap futures as a capital-efficient alternative to over-the-counter (OTC) swaps. Our partnership with Eris, like our partnership in CurveGlobal, positions CBOE to capitalize on the continuing convergence of the OTC and listed markets by bringing new products and efficiencies to the interest rate marketplace.

The timing of the partnership is especially opportune as it allows our two companies to collaborate on developing product solutions designed to address the impact of pending international regulatory reforms, including Basel III and European swap clearing and trading mandates. The partnership also enables us to enhance distribution of Eris Interest Rate Swap Futures and related market data.

In June, we entered into an exclusive licensing agreement with Social Market Analytics (SMA), a leader in providing actionable intelligence from social media sources. Extracting information from social media represents a promising new frontier in strategy benchmarking, and our research suggests a high correlation between SMA's metrics and price movements in stocks. We welcome the opportunity to develop sentiment-based benchmark indexes based on SMA data and expect to introduce the first of these benchmarks this summer.

I'll close here by saying we are obviously pleased with our strong second-quarter results on the heels of a similarly strong first quarter. Our solid year-to-date performance is the result of a companywide commitment to a strategy designed to benefit our customers and shareholders over the long term. Market events continue to highlight CBOE's growing importance in the global marketplace, and for that I thank the entire CBOE team. Their ability to develop unique products, leverage strategic partnerships, and expand our customer base enables us to lead the options and volatility space globally and drives our company's forward momentum.

With that, I will turn it over to Alan Dean.

Alan Dean, CFO

Thanks Ed and good morning everyone.

I am pleased to provide an overview of our second-quarter financial results. Positive momentum in our proprietary products carried over into the second quarter, resulting in another solid quarter. Operating revenue came in at $163.3 million, 10 percent above last year's second quarter. Adjusted operating income was $79.5 million, up 8 percent versus last year. Adjusted operating margin was 48.7 percent, down 60 basis points compared with 49.3 percent in the second quarter of 2015. Adjusted net income allocated to common stockholders was $48.7 million, up 9 percent versus the second quarter of 2015, resulting in adjusted diluted earnings per share of $0.60, an 11 percent increase compared with $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 2016 include certain unusual items that impact the comparison of our operating performance and that we believe are not indicative of our core operating performance. These items are detailed in our non-GAAP information provided in the press release and in the appendix of our slide deck.

Looking at our results further, starting with adjusted operating revenue, we reported increases in transaction fees and exchange services and other fees, partially offset by a decrease in other revenue.

Transaction fees were up $16.3 million, or 16 percent, compared with the second quarter of 2015, driven by a 10 percent increase in average revenue per contract (or RPC) and a 6 percent increase in total trading volume versus last year's second quarter.

Looking at volume by product category, as shown on this slide, our higher-RPC proprietary products significantly outperformed the lower-RPC multiply-listed options, with trading in our index options up 19 percent and futures up 43 percent over last year's second quarter. For the multiply-listed products, options on exchange-traded products increased 3 percent while equity options declined 10 percent.

Our blended RPC, including options and futures, increased to 40.5 cents from 36.8 cents in last year's second quarter. The increase in RPC primarily reflects a favorable shift in the mix of trading volume, with our highest-RPC products, index options and futures contracts, accounting for 42.9 percent of contracts traded in the second quarter compared with 37.2 percent in the same period last year.

The RPC in our options business increased to 32.8 cents compared with 30.8 cents in the second quarter of 2015, again, reflecting the shift in trading volume towards our index options, which generate the highest options RPC. Index options accounted for 39.4 percent of options trading volume versus 34.4 percent in last year's second quarter. Somewhat offsetting the increase, RPC for equity options and exchange-traded products decreased 24 percent and 12 percent, respectively, primarily due to the mix of account type and higher volume discounts and incentives.

Revenue per contract at CFE, our futures exchange, decreased 4 percent to nearly $1.68 from $1.76 in last year's second quarter, reflecting the impact of higher rebates linked to volume and account type.

Looking at RPC on a sequential basis, the blended RPC for the second quarter of 40.5 cents was unchanged from the first quarter, primarily reflecting the positive impact of increased trading from our highest RPC futures contracts, which accounted for 5.7 percent of trading volume versus 4.5 percent in the first quarter.

The revenue contribution from our proprietary products continues to increase as a percentage of total transaction fees. In the second quarter, proprietary products accounted for 87.9 percent of our transaction fees, up from 82.4 percent in the second quarter of 2015 and 85.8 percent in the first quarter of 2016.

Looking at some of the other factors influencing adjusted operating revenue, exchange services and other fees increased by $1.6 million. Similar to prior quarters, this increase was largely due to revenue contributed from CBOE Livevol technology services, which became part of CBOE Holdings on August 7, 2015.

Other revenue was down $4.2 million, primarily due to lower revenue from fines. In 2015, revenue from fines was higher than normal, resulting in more difficult comparisons this year, a trend we currently expect to continue in the second half of the year. Revenue from fines is pooled with regulatory revenue and is used to support our regulatory functions.

Turning to expenses, this next slide details adjusted operating expenses of $83.8 million, for the quarter, an increase of $8.5 million or 11 percent, compared with $75.3 million in last year's second quarter. Adjusted operating expenses for the quarter mainly reflect higher costs for compensation and benefits, royalty fees and professional fees and outside services.

Core operating expenses were $52.7 million, an increase of $6.0 million or 13 percent, compared with the second quarter of 2015.

This increase primarily reflects higher costs of $3.5 million in compensation and benefits and $1.8 million in professional fees and outside services. The variance in compensation and benefits largely reflects higher salaries and incentive-based compensation. The increase in salaries primarily resulted from staffing additions, particularly in our systems and business development groups, as well as the addition of Livevol. The variance in incentive-based compensation is aligned with our improved financial performance. The increase in professional fees and outside services primarily reflects higher costs for legal fees and regulatory contract services.

We are reaffirming our guidance for core expenses for the year to be in the range of $211 million to $215 million. We do expect core expenses to increase in the second half of the year versus the first and second quarters. As we noted on our previous earnings call, under our regulatory services agreement with FINRA, we completed our migration to FINRA's regulatory software in July, which resulted in an increase in fees paid to FINRA. This increase is expected to be offset somewhat by lower depreciation and amortization expenses due to the final write off of certain regulatory software, however, it shifts some expenses into core going forward, that were previously in depreciation and amortization.

Looking at volume based-expenses, royalty fees increased by $2.5 million, or 15 percent, reflecting the higher trading volume in licensed products during the quarter.

The royalty rate per licensed contract traded came in at 15.5 cents this quarter, in line with the rate we saw in the first quarter. As I noted in prior quarters, the rate per contract can vary based on the mix of index products traded.

One final note on our income statement, included in investment and other income this quarter is revenue of $5.5 million, which we received from a settlement for attorney fees and expenses relating to a litigation matter. This item is included in our non-GAAP reconciliation.

Turning to the balance sheet, we finished the quarter with cash and cash equivalents of $52 million, compared to $107 million at the end of the first quarter and $102 million at the end of 2015. The decrease in cash compared to the previous quarter ending March 31, was primarily due to income tax payments made during the quarter, in addition to our other uses of cash for dividends and share repurchases.

CBOE is a strong cash producing business. Through June, we generated net cash flows from operating activities of $115 million versus $106 million in the same period last year, largely driven by the increase in net income.

Capital expenditures to date were $25 million. Looking out to the end of the year, we are reaffirming our prior guidance of $47 to $49 million for capital spending.

The majority of our capital spending continues to be systems related, particularly with the ongoing development of our new trading platform, CBOE Vector. We now expect Vector to be up and running for CFE, our futures exchange, by the end of this year. After the CFE implementation, we plan to continue the development of Vector for CBOE and C2.

We remain committed to using our cash flow to optimize shareholder value by first reinvesting in our business, and then returning excess cash to shareholders through sustainable dividends and share repurchases.

In line with that commitment, year-to-date through June we have used more than $38 million to pay dividends and nearly $65 million to repurchase our stock. At June 30, we had approximately $97 million remaining under our existing share repurchase authorizations.

In addition, we continue to invest in long-term growth opportunities, such as our minority equity investment in the Eris Exchange, which Ed mentioned in his remarks.

Further underscoring our commitment to returning capital to shareholders, we were pleased to announce, yesterday, that our Board declared an increased quarterly dividend of $0.25 per share. This represents a 9 percent increase compared to the prior quarterly dividend. This dividend increase marks the sixth consecutive year that our Board has increased our dividend, representing a compound annual growth rate of 17 percent.

In closing, we will continue to focus on and invest in our long-term growth initiatives. As the industry's leading provider of index and volatility products, CBOE is well-positioned to meet the needs of market participants and drive long-term value for our shareholders.

With that, we thank you for your time and attention this morning and I will turn it back over to Debbie for instructions on the Q&A portion of the call.

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.

Closing:

That completes our call this morning. We appreciate everyone's participation today and your interest in CBOE. We look forward to speaking with you on our next conference call. I will be available today for any follow-up questions you may have.

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; the accuracy of our estimates and expectations; legislative or regulatory changes; increasing competition by foreign and domestic entities; our index providers ability to perform under our agreements; 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, 2014 and other filings made from time to time with the SEC.