CBOE HOLDINGS, INC.
First Quarter 2017 Earnings Call - Prepared Remarks
Tuesday, May 9, 2017

Debbie Koopman

Good afternoon and thank you for joining us for our first quarter conference call. On the call today, Ed Tilly, our CEO, will discuss the quarter and our strategic initiatives for 2017. Then, Alan Dean, our Executive Vice President and CFO, will detail our first-quarter 2017 financial results and provide updated guidance on certain financial metrics for 2017. Following their comments, we will open the call to Q&A. Also joining us for Q&A will be our President and COO, Chris Concannon and our Chief Strategy Officer, John Deters.

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.

During our remarks, we will make some 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.

During the course of the call this morning, we will be referring to non-GAAP measures as defined and reconciled in our earnings materials. We will also refer to pro forma results, which are also reconciled in our earnings materials. As you know, we completed our acquisition of Bats Global Markets, Inc. on February 28, 2017. The pro forma results present information regarding the combined operations as if the Bats acquisition had closed at the beginning of 2016, in order to provide a more meaningful discussion of our results.

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

Ed Tilly, CEO

Good morning and thank you for joining us today.

Before we begin our formal remarks, I would like to welcome Chris Concannon, our new President and COO, to his first CBOE quarterly earnings call. Many of you already know Chris and the talents he brings to the CBOE leadership team.

Turning to the quarter, I am pleased to report on a strong first-quarter 2017 at CBOE Holdings, with adjusted earnings per share of $0.78 on net revenue of $193.4 million. Our first-quarter performance built on last year’s solid financial results and continued growth in index trading, led by record trading in SPX options.

Our big news for the quarter, of course, was the completion of the acquisition of Bats Global Markets on February 28th. I’ll have more on that in a moment, but first will note that we continued to focus on our core business and maintained strong organic growth in the period leading up to and after the close.

Our options volume during the first quarter was up 9 percent over the previous year, and our proprietary products continued to outperform the industry. We saw record trading in SPX options, which increased 15 percent over the first quarter of 2016. VIX futures trading had its third-busiest quarter to date and increased 18 percent year-over-year. We saw similar trends in April with our proprietary products.

In our new lines of business from the Bats transaction, we saw first-quarter market share in U.S. Equities decrease by two percentage points against the prior year's first quarter, reflecting lower volatility this year and a record quarter last year. European Equities market share was down by about two percentage points from the first quarter last year. And, while overall Global FX volume was down in the first quarter, our market share grew to a record high 12.9 percent compared to 11.8 percent a year ago.

Moving on now to our integration with Bats. Getting this integration right is our greatest opportunity to benefit our shareholders, customers and employees. I'll use the remainder of my time here to discuss our vision, progress to date and next steps for fully leveraging our Bats investment.

I'll begin by reiterating the four major areas of benefit we expect to see for the deal.

First it grows our company and allows us to scale up, enabling us to increase our profit margins and strategic optionality. The acquisition also increases our recurring non-transaction revenue and furthers enhances our strong growth and margin profile.

Second, it significantly diversifies our product line into new asset classes and geographies, creates new revenue sources, attracts new users to our marketplace and enables us to efficiently provide packaged offerings, particularly for our large customers.

Third, it enhances innovation at CBOE by giving us the opportunity to shape and capture revenue from every aspect of the product development and trading cycle. With the addition of Bats' global ETF listing and trading venues, we can now design new indexes, list them, educate more customers on how to trade them, and generate and package market data to deliver incremental revenue and create new products.

The new asset classes and geographies brought to us by Bats are building blocks for innovation. We plan, for instance, to leverage CBOE's derivatives expertise and Bats' European and FX footprint to create unique products and to apply our indexing expertise to Bats growing European index business. I'll mention here that Bats rolled out the Bats Brexit 50/50 Indexes in March, ten benchmark indexes on European markets in April and plans to launch a Pan-European index later this quarter.

Fourth, the acquisition grows our customer base and immediately affords us the opportunity to cross-sell additional products and services to more customers.

Now an early progress report on the integration. We began on Day One to execute a detailed plan developed well ahead of the close in order to immediately begin to realize the benefits of joining our two companies.

We reconfigured our combined business development and sales operations to leverage our newly expanded product line and geographic reach. Bats brings a much greater physical presence in New York and Europe to CBOE, enabling us to significantly increase boots on the ground in those locations as we begin cross-promoting a broader product line globally. We consolidated offices in locations where there was overlap and are integrating our expanded global sales force to more efficiently reach customers and improve their experience.

While Bats extends our global reach, CBOE brings a robust Marketing and Educational offering to the combined company. This gives us to the opportunity to efficiently raise the profile and understanding of Bats products and markets, which are already being incorporated into our customer-facing efforts.

Our annual U.S. Risk Management Conference in March, for instance, was our first as a combined company, and we will showcase our expanded product line later this year at our European and Asian RMC events. We are similarly expanding The CBOE Options Institute curriculum to include educational content on Bats products, while significantly expanding our educational breadth and reach with the addition of ETF.com.

We have greatly expanded and reconfigured our R&D area to comprehensively approach the tremendous opportunity we see for increased innovation. Our newly launched Multi-Asset Solutions Division was structured to apply CBOE's innovation expertise to a much broader array of products and services.

The new Division incorporates Product Development, Market Research and Information Solutions, which includes Indexing, Data and Analytics, and Execution Services. This integrated approach positions our team to innovate across product lines and geographies and to collaborate with market participants, such as index providers and customers, and new partners, such as ETP issuers.

I should note here that in light of our growing index business, CBOE recently joined the Index Industry Association (IIA), which includes leading global index providers, such as our partners, S&P/Dow Jones Indices, FTSE Russell and MSCI.

Going forward, our expanded product and services offering will ultimately be powered by Bats' leading proprietary trading technology. Migrating our trading technology onto Bats proven platform underpins the scale and efficiency we expect to gain from the CBOE Bats combination. We are laser-focused on working closely with customers to ensure a seamless technical and operational integration.

On March 29, we hosted the first in a series of customer conference calls on technology integration and the migration of CBOE's exchanges onto the Bats technology platform. CIO Chris Isaacson provided a detailed roadmap for CFE's migration, which we expect to complete in February 2018, followed by C2 and then CBOE. Our next systems integration customer call, scheduled for June 6th, will provide additional information on the C2 migration timeline. In other technology news, we also held a customer conference call last Thursday to introduce the new complex order book functionality being offered by the Bats EDGX Options Exchange expected to launch in October.

In closing, I would like to thank the entire combined CBOE team. Our ability to hit the ground running on Day One is a credit to the sustained efforts of the legacy CBOE and Bats teams in our intensive integration planning and preparation prior to the close. These are the very early days of two dynamic and innovative companies coming together. A shared competitive spirit has inspired our teams to bring forth the best of each culture to make our combined company the best it can be. We could not be more excited about the opportunities that lie ahead now that we are operating as one company and one team.

With that, I thank you for your time and will now turn it over to Alan.

Alan Dean, CFO

Thank you Ed and good morning.

Before I get into the details of our first-quarter results, let me point out that our GAAP, or reported, first-quarter 2017 results include Bats for the month of March. Therefore, the year-over-year variances on a GAAP basis were largely due to the addition of Bats on March 1. To provide a more meaningful review of our business, I will speak to the combined results of CBOE and Bats for the full quarter. So my remarks today will primarily focus on our pro forma non-GAAP results, which present financial results to reflect the Bats transaction as if it had occurred on January 1, 2016. On that basis, for the combined company, we saw strong results for the quarter despite weaker trading activity across U.S. and European equities and derivatives markets overall. Our results were primarily fueled by the strength of our proprietary index products and growth in our non-transaction revenue, which offset weaker trading activity in U.S. and European equities, and we're off to a strong start on our cost synergy targets.

Summarizing our pro forma adjusted results, net revenue was $265.3 million, up 4 percent above last year's first quarter. Operating expenses were $106.3 million, up 4 percent and the operating margin increased 10 basis points versus last year's first quarter. Diluted earnings per share of $0.86, was up 25 percent over the prior year period.

Looking at our results further, starting with net revenue, we reported increases in transaction fees, exchange services and other fees, market data fees and other revenue.

Generally, we saw mixed performance by business segment with futures achieving the largest revenue increase, followed by options. U.S. and European equities were relatively flat to down as those segments faced a more challenging trading environment this year and difficult comparisons against record results posted in last year's first quarter. However, strong growth in non-transaction revenue in these segments offset shortfalls in net transaction fees. I'll get into this in more detail later when I review each business segment. Non-transaction revenue accounted for 42.9 percent of total net revenue in the first quarter of 2017, up 160 basis points from 41.3 percent in 2016's first quarter.

As a result of the acquisition and related organizational changes, we are now reporting on five business segments: Options, U.S. Equities, Futures, European Equities and Global FX. Results for fiscal periods prior to first quarter 2017 are presented to conform to the new segments.

Looking at the revenue contribution by segment, pro forma net revenue from options accounted for 51 percent of total net revenue and was up $2.9 million, or 2 percent, compared with the first quarter of 2016. The increase was primarily driven by higher revenue from net transaction fees, exchange services and other fees, market data fees and other revenue, offset somewhat by an increase in royalty fees, versus last year's first quarter.

Net transaction fees for options was up $1.5 million in the first quarter, with higher revenue from index options offset somewhat by a decline in multiply-listed options. Transaction fees from our higher-RPC index options were $85 million, up $5 million or 6 percent. This increase was due to a 7 percent increase in ADV over last year's first quarter, led by record quarterly ADV of 1.1 million contracts for SPX options, offset somewhat by a 2 percent decrease in RPC. Transaction fees from multiply-listed options of $18 million was down $4 million or 18 percent, reflecting a 9 increase in ADV offset by a 27 percent decrease in RPC, resulting from higher volume-related incentives achieved by trading participants.

The increase in options market data fees was primarily due to gains in our share of U.S. options transactions this quarter compared to last year's first quarter. Total market share for CBOE Holdings was 41.4 percent for the first quarter of 2017, up from 36.8 percent in the first quarter of 2016. Furthermore, Bats BZX and Bats EDGX exchanges, achieved record market share of 11.5 percent for the quarter, up from 10.2 percent in last year's first quarter.

Moving to Futures, our fastest growing and highest RPC business segment posted strong first quarter net revenue of $28.8 million, up 37 percent. This increase resulted from higher transaction fees, driven by an 18 percent increase in ADV for CFE and a 10 percent increase in RPC. Futures RPC reached a new quarterly high of $1.81, up from $1.64 in last year's first quarter, reflecting the impact of fee changes implemented in January 2017.

Looking at CBOE's organic growth from options and futures, excluding the Bats revenue contribution, you can see that we had strong organic growth of 8 percent, driven by the strength of our proprietary products, particularly VIX futures and SPX options. In the first quarter, proprietary products accounted for 88.9 percent of Legacy CBOE's net transaction fees, up from 85.8 percent in the first quarter of 2016. On a pro forma basis, proprietary products accounted for 65.9 percent of net transaction fees in the first quarter of 2017 compared to 59.9 percent in the first quarter of 2016.

Turning to U.S. Equities, net operating revenue was essentially flat reflecting a 21 percent decline in market volumes and a 2.1 percentage point decrease in market share, offset by a 21 percent increase in net capture - reflecting difficult comparisons against last year's record market share and trading activity. Generally, during periods of low volatility such as we experienced in the first quarter of 2017, overall equities volumes decline and a higher percentage of shares are traded off-exchange. However, we were pleased that the strong contribution from our non-transaction revenue, including exchange services and other fees and market data fees, offset the decline in net transaction fees.

Faced with a similar environment, net revenue for European equities declined 4 percent, however, the decrease was primarily due to the stronger dollar relative to the pound sterling. In local currency, net revenue grew 11 percent to £14.4 million in the first-quarter 2017 from £13.0 million in the first-quarter 2016, primarily due to growth in non-transaction revenue. Net transaction fees also increased, although to a lesser degree, despite a 15 percent decline in overall market average daily notional value (ADNV) and difficult market conditions, which was offset by an 18 percent increase in net revenue capture.

For the first quarter of 2017, Bats retained its position as the largest European stock exchange with 21.5 percent market share.

Net revenues for Global FX rose 4 percent to $10.8 million in the first quarter of 2017. This increase was due to access fees implemented in the third quarter of 2016. In addition, market share reached a new high of 12.9 percent for the first quarter.

During the first quarter of 2017 nearly $29 billion of average daily notional value traded on the Hotspot FX platform, down slightly from just over $29 billion in last year's first quarter.

Turning to expenses, this next slide details total adjusted pro forma operating expenses of $106.3 million for the quarter, up $3.7 million compared with last year's first quarter. Looking at the expenses in detail, you see higher costs for compensation and benefits, offset by lower costs for depreciation and amortization. The increase in compensation and benefits largely reflects higher incentive-based compensation, which is aligned with our financial performance.

Looking at our progress on cost synergies we expect to achieve from the Bats acquisition, as we disclosed previously, we expect to achieve $50 million in annualized expense synergies by year three and $65 million by year five. As Ed noted, we hit the ground running day one and while it's still early days, we are making solid progress executing on our integration plans and as a result the realization of synergies is ahead of plan. As this slide shows, we now expect to end the year with $20 million in GAAP run-rate synergies for 2017, as we anticipate realizing some of the synergies earlier than previously expected to arrive at the $50 million run rate in year three. For the first quarter we realized

$2.4 million pre-tax in expense synergies, primarily in compensation and benefits and professional services, On a cash basis, the run-rate synergies for 2017 are about $5 million higher, or $25 million, primarily reflecting lower expenditures for capitalized software. We think these targets are highly achievable and will update you as we make further progress in the integration process.

Turning to guidance, the following information details our expectations for certain financial metrics for the full-year 2017, taking into account our acquisition of Bats.

Starting with expenses, we now expect total operating expenses to be in a range of $415 to $423 million. This guidance excludes acquisition-related expenses, accelerated stock-based compensation and amortization of acquired intangible assets that will be included in our non-GAAP reconciliation.

In 2016, CBOE and Bats combined had adjusted operating expenses of $417 million, so our 2017 guidance for operating expenses represents a change of up 1 percent to down 1 percent.

Our guidance for 2017 primarily reflects higher expenses for compensation and benefits and lower depreciation and amortization expense. The increase in compensation and benefits primarily reflects merit increases, higher incentive-based compensation, and a ramp-up in hiring to appropriately staff the maintenance and operations of two trading platforms, as well as to execute the multi-year migration to the Bats technology platform. The decrease in depreciation and amortization is primarily due to the roll-off of fully-depreciated assets.

Depreciation and amortization expense, which is included in our total expense guidance is expected to be between $52 to $54 million, excluding amortization of acquired intangible assets of about $169 million, which will be excluded from our non-GAAP results. On a combined basis, CBOE and Bats incurred D&A expenses of $57 million in 2016, excluding the amortization of acquired intangible assets.

We expect our effective tax rate for 2017 to be in the range of 35 and 37 percent. For 2016, CBOE's effective tax rate was 39.4% and Bats' was 39.0%. The effective tax rate outlook includes the adoption of new accounting guidance by CBOE in 2017, that requires the excess cash benefit or expense relating to the exercise of stock options and vesting on restricted stock to be reported in income tax expense versus through equity under previous guidance. This change in accounting guidance may have a favorable or unfavorable impact on our tax rate going forward depending upon the future stock price and the concentration of the stock awards vesting.

Additionally, the tax rate reflects the benefit of re-characterizing our European operations from a U.S. tax perspective.

Moving on, capital spending in 2017 is expected to be between $55 to $60 million, which includes spending to migrate the CBOE exchanges onto the proprietary Bats technology, while continuing to invest in systems to support CBOE's current trading technology. In 2016, CBOE's capital spending was $44 million and Bats' was $9 million.

Let me touch on interest expense and debt. To fund the cash portion of the Bats acquisition, as well as the repayment of Bats' existing indebtedness and certain transaction costs, we obtained borrowings of $1.65 billion, including a $1 billion five-year term loan and $650 million in 3.650% senior notes.

The interest and fees for the senior notes are expected to result in interest expense of about $24.2 million for the full-year 2017, a little over $6.0 million each quarter. The $1 billion term loan has an initial interest rate of 2.304 percent based on 3 month LIBOR plus 1.25 percent per annum. This rate is subject to change based on credit rating, in a range from 1.00 to 1.75 percent.

Before I wrap up, let me touch on our capital management objectives. First and foremost, we plan to continue to invest in the growth of our business, return capital through dividends and utilize excess cash to pay down the five-year term loan as quickly as possible.

We ended the first quarter with cash of $153 million and a strong cash flow position that enabled us to reduce our debt by $150 million. While I do plan to continue to utilize cash to pay down debt, I wouldn't use the first quarter payment as a quarterly run rate since our cash needs may vary from quarter to quarter. Our debt to EBITDA ratio based on trailing twelve months adjusted pro forma EBITDA at quarter end was 2.4 times, which is down from 2.6 times on the date of the Bats acquisition. And, while we don't have a specific leverage ratio target we are managing to, we will look to continue to reduce our debt to enhance our balance sheet flexibility.

While we are not currently active in our share repurchase program, we continue to take an opportunistic approach, and may make opportunistic share repurchases depending on the circumstances.

To summarize, we're off to a strong start this year. Our first quarter results demonstrate:

- The strength of our proprietary index products, generating strong organic growth
- Diversifying and stabilizing our revenue streams with our increased mix of non-transaction revenues
- Disciplined expense management
- Leveraging the scale of our business model, producing higher operating margins
- An integration plan on track, with a strong start to cost synergy realization
- Ongoing focus on capital allocation, reducing debt by $150 million

Overall, we remain focused on positioning the company for long-term success by delivering profitable growth while managing costs effectively. We are well positioned to build on our strong foundation and look forward to updating you on our progress.

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

Debbie Koopman

At this point, we would be happy to take questions. I would like to remind you to please keep your questions focused on the topic of guidance.

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

That completes our call this morning. We appreciate your time and continued interest in our company.

Cautionary Statements Regarding Forward-Looking Information:

This presentation contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve a number of risks and uncertainties. You can identify these statements by forward-looking words such as may, might, should, expect, plan, anticipate, believe, estimate, predict, potential or continue, and the negative of these terms and other comparable terminology. All statements that reflect our expectations, assumptions or projections about the future other than statements of historical fact are forward-looking statements. These forward-looking statements, which are subject to known and unknown risks, uncertainties and assumptions about us, may include projections of our future financial performance based on our growth strategies and anticipated trends in our business. These statements are only predictions based on our current expectations and projections about future events. There are important factors that could cause our actual results, level of activity, performance or achievements to differ materially from those expressed or implied by the forward-looking statements.

We operate in a very competitive and rapidly changing environment. New risks and uncertainties emerge from time to time, and it is not possible to predict all risks and uncertainties, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Some factors that could cause actual results to differ include: the loss of our right to exclusively list and trade certain index options and futures products; economic, political and market conditions; compliance with legal and regulatory obligations; increasing price competition in our industry; decreases in trading volumes or a shift in the mix of products traded on our exchanges; legislative or regulatory changes; increasing competition by foreign and domestic entities; our dependence on third party service providers; our index providers' ability to maintain the quality and integrity of their indexes and 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 accommodate trading volume and transaction traffic, including significant increases, without failure or degradation of performance of our systems; our ability to protect our systems and communication networks from security risks, including cyber-attacks; the accuracy of our estimates and expectations; our ability to maintain access fee revenues; our ability to meet our compliance obligations, including managing potential conflicts between our regulatory responsibilities and our for-profit status; the ability of our compliance and risk management methods to effectively monitor and manage our risks; our ability to attract and retain skilled management and other personnel; our ability to manage our growth and strategic acquisitions or alliances effectively; restrictions imposed by our debt obligations; unanticipated difficulties or expenditures relating to the recently-completed acquisition of Bats Global Markets, Inc., including, without limitation, difficulties that result in the failure to realize expected synergies, efficiencies and cost savings from the acquisition within the expected time period (if at all), whether in connection with integration, combining trading platforms, broadening distribution of product offerings or otherwise; our ability to maintain an investment grade credit rating; disruptions of our current plans, operations and relationships with market participants caused by the Bats acquisition; and potential difficulties in our ability to retain employees as a result of the Bats acquisition. More detailed information about factors that may affect our actual results to differ may be found in our filings with the SEC, including in our Annual Report on Form 10-K for the year ended December 31, 2016 and other filings made from time to time with the SEC.

We do not undertake, and expressly disclaim, any duty to update any forward-looking statement whether as a result of new information, future events or otherwise, except as required by law. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.