CBOE HOLDINGS, INC.
Second Quarter 2017 Earnings Call - Prepared Remarks
Friday, August 4, 2017

Debbie Koopman, VP, Investor Relations

Good morning and thank you for joining us for our second quarter conference call. On the call today, Ed Tilly, our Chairman and CEO, will discuss the quarter and our strategic initiatives for 2017. Then, Alan Dean, our Executive Vice President and CFO, will detail our second-quarter 2017 financial results and provide updated guidance on certain financial metrics for 2017 and Brian Schell, our Deputy CFO, will provide an update on the capital management front. 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 non-GAAP adjusted combined 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 combined results present information regarding the combined operations as if the Bats acquisition had closed at the beginning of 2016, in order to provide a supplemental discussion of our results.

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

Ed Tilly, Chairman and CEO

Good morning and thank you for joining us today.

Before I begin today, I would like to acknowledge the passing of our friend and colleague, Magnus Bocker. Several of us at CBOE had the pleasure to come to know Magnus while laying the groundwork for our educational partnership with SGX. We are personally saddened and, on behalf of CBOE, I wish to extend our condolences to our friends at SGX and others throughout the industry who mourn his loss.

Moving on now to our quarterly results. I am pleased to report on a strong second-quarter 2017 at CBOE Holdings, with adjusted earnings per share of $0.87 on net revenue of $267 million, led by continued growth in our proprietary index products.

Our overall options volume during the second quarter was up 15 percent over the previous year, and our proprietary products continued to outperform the industry. We established an all-time record quarter in VIX futures trading, which increased 19 percent over the second quarter last year. Our index options volume increased 9 percent, reflecting the third-highest quarter for VIX options trading and continued growth in SPX options volume. We continued to see strong trading in our proprietary products in July led by VIX options, which had their busiest month this year.

We have grown accustomed to increased VIX trading amidst spikes in volatility, but we are obviously seeing that low volatility environments create trading opportunities as well. While VIX-linked ETPs remain key to the VIX ecosystem, we believe the most recent increases in volume can be attributed to a growing group of users trading VIX futures directly rather than using VIX ETPs. We are also seeing VIX options trade in greater size and users continuing to find utility trading VIX futures and options, regardless of the VIX Index level.

In other business lines, global FX volume was up 8 percent in the second quarter and our market share stood at 12.9 percent at the end of June, compared to 11.5 percent a year ago. We saw second-quarter market share in both U.S. and European Equities decrease against the prior year's second quarter, due to this year's continued low volatility. Our Bats ETF Marketplace, however, continues to thrive and grow.

Our growing market share in ETF listings demonstrates our ability to offer meaningful benefits for issuing firms and deep liquidity to market participants. We are now home to over 221 ETFs, 89 of which were added this year. Of those, 30 are BlackRock iShares funds which transferred from a competing marketplace earlier this week.

Year-to-date, we have won 39 percent of all new ETF listings -- our highest-ever percentage -- including some of the largest ETF launches this year: five of this year's top 10 new ETFs in terms of assets under management are listed on Bats. We also listed our first Exchange Traded Notes this past quarter.

With the addition of new funds from some of the industry's most influential firms -- including Franklin Templeton, Janus/UBS and Principal -- and new opportunities to leverage our global presence and CBOE brand, we expect our listings business to gain even more momentum.

We took an exciting step toward further expanding our growing product line this week by entering into an agreement with Gemini Trust Company that provides CBOE with a multi-year exclusive global license to use Gemini's market data, including Gemini Bitcoin Auction values, to create bitcoin derivatives products. We are working closely with the CFTC and, subject to regulatory review, we intend to offer trading in cash-settled bitcoin futures on CFE in the fourth quarter of 2017 or early 2018. CBOE will also retain exclusive rights to use Gemini market data for the creation of new indexes, as well as rights to distribute Gemini market data over CBOE's market data feeds.

As you know Gemini previously selected Bats Global Markets to list their proposed bitcoin exchange-traded fund. We could not be more pleased to build on that partnership by leveraging CBOE's experience in product innovation in cutting-edge asset classes to develop and trade bitcoin futures. The collaboration with Gemini is an example of the strong potential for innovation we see in marrying ETP issuer relationships, ideas and capabilities with CBOE's deep product development expertise. We look forward to responding to the growing interest in crypto-currencies through potential bitcoin futures traded on a regulated derivatives exchange, with the many expected benefits this brings, including transparency, price discovery, liquidity and centralized clearing.

Moving on now to our integration with Bats. As mentioned in our last call, the combination of the two companies provides us the opportunity to cross-sell additional products and services to an expanded customer base.

We continue to focus on our core index business and target the OTC space with quality listed products, while extending our global reach to promote an expanded product line. I'm pleased to announce we will be opening a satellite Hong Kong/APAC office in the third quarter, while continuing to leverage our presence in London and Singapore.

Our coordinated efforts across multiple locations in the U.S. and abroad enable our equities, derivatives, and FX sales teams to interact more frequently and efficiently with a greatly expanded base of buy-side and sell-side clients. Our extended reach enables us to build closer, more collaborative relationships with local brokerage firms and indexers and accelerates our ability to cross-promote our products to a much broader audience.

We are preparing for our sixth annual CBOE Risk Management Conference Europe, which runs from September 11-13. This will be our first RMC Europe held in near London, and the first to feature team members who now represent new lines of CBOE business, including FX products and European equities. RMC typically attracts sophisticated traders who are early adopters of our new products. We very much look forward to sharing our expanded offering with many of our most influential customers.

As you know, the migration of our trading technology onto Bats' proven platform underpins the scale and efficiency we expect to gain from the CBOE-Bats combination. We remain laser-focused on working with customers to help ensure a seamless technical and operational integration.

Last quarter, we held the second in a series of customer conference calls on the migration of CBOE's exchanges onto the Bats technology platform. On that call, we announced that we expect to complete the C2 options exchange on May 14, 2018, which follows the previously announced migration of the CBOE Futures Exchange (CFE) to the Bats platform planned for February 25, 2018. We expect to announce the date for CBOE's migration in the coming quarters as we continue to work on requirements for the hybrid floor and electronic system.

We are also implementing a new index technology platform that will serve as the foundation for our growing index business and enable us to better calculate and disseminate data for new and existing indices. Completion of the new index platform is expected in the first half of 2018 and we will announce a full roll-out schedule in upcoming technology integration customer calls.

Turning to our European equities business and the progress we've made toward addressing the challenges and opportunities inherent in MiFID II. Bats Europe is nearing completion of its technical and operational readiness, having successfully implemented a strategic plan that allows ample time for customers to test our systems and prepare for MiFID II. Last month, we successfully completed our third and most significant software release of the year, which included all of the real-time exchange functionality needed for MiFID II compliance. Our final software release is scheduled for October.

Importantly, we also see MiFID II as an opportunity to provide value-added products and services to help customers navigate the changing regulatory environment. These include our Large in Scale, Periodic Auctions and expanded buy-side trade reporting services.

The new volume caps coming under MiFID II will limit trading in dark venues, causing investors to seek new places to trade with minimal market impact. Our Large in Scale and Periodic Auctions offerings are designed to enable investors to find liquidity and trade large quantities of stock without the associated market impact.

We continue to see rapid uptake in trading on our Large in Scale service, a block-trading platform launched last December with BIDS, a block-trading leader in the U.S. More than 86 buy-side customers are now connected and we continue to see increased traded on the new platform.

The trading experience on the Periodic Auctions offering, a lit book operating auctions throughout the day, allows market participants to trade in increased size without significant reactive market movements. We believe we will see strong traction in our Periodic Auctions offering as we near MiFID II commencement.

Last quarter, we expanded our Europe Trade Reporting (BXTR), the largest equity trade reporting facility in Europe, to enable buy-side firms to meet their trade reporting obligations under MiFID II by allowing their brokers to submit trade reports using their existing connectivity to Bats Europe.

Turning now to our U.S. equities and our Bats Market Close proposal -- we continue to receive questions on this initiative, so I will take a moment here for an update. Bats Market Close is a near end-of-day match process for non-Bats listed securities that we created in response to customer demand. It would provide a means to secure primary market closing print prices without disrupting the primary market closing auctions that take place at the end of the U.S. equities trading day.

On July 6, the SEC extended the Bats Market Close review period another 45 days, making August 20th its next action date. At that time, the SEC may either approve or institute a proceeding to disapproval, which would give them another 180 days to act. We remain strongly committed to the customer benefits of this initiative, which are highlighted in our response letter to the SEC earlier this week, and we will continue to advocate for its approval.

In closing I would like thank the CBOE team for a great second quarter, our first full quarter as a combined company with Bats. It is a credit to the talent and professionalism of the entire team that we continue to systematically hit our internal integration milestones, while delivering strong results in our core business lines and positioning the company for future success through the consistent execution of our strategic growth initiatives. I am excited about the opportunity that lies ahead for this team to leverage our expanded product line and extended global reach to continue to grow CBOE and reward our shareholders for years to come.

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 begin, let me point out that our GAAP, or reported, second-quarter 2017 results include Bats for the entire quarter this year but not the comparable 2016 period. Therefore, the year-over-year variances on a GAAP basis were largely due to the addition of Bats on March 1. To provide an additional review of our business, my remarks will focus on our non-GAAP adjusted combined 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 second quarter, primarily driven by the continued strength of our proprietary index products and growth in non-transaction revenue, against the backdrop of subdued market volatility and essentially flat U.S. equities and options trading activity quarter over quarter.

Summarizing our adjusted combined results, net revenue was $266.9 million, up 5 percent above last year's second quarter. Operating expenses were $101.3 million, down 5 percent and the operating margin increased 410 basis points versus last year's second quarter to 62.0 percent. Diluted earnings per share of $0.87, was up 16 percent over the prior year period.

Looking at our results further, starting with net revenue, our revenue growth was primary fueled by increases in transaction fees, market data fees and exchange services and other fees.

Turning to the revenue contribution by business segment, you can see that we achieved higher revenue across each business segment with futures contributing the largest increase. We also benefited from the diversity of our revenue streams, with growth in non-transaction revenue in U.S, equities offsetting the shortfall in net transaction fees in that business. I'll get into this in more detail later when I review each business segment.

In our options segment, adjusted combined net revenue of $126.7 million was up $2.1 million, or 2 percent, compared with the second quarter of 2016. The increase was primarily driven by higher revenue from net transaction fees, exchange services and other fees, and market data fees, offset somewhat by an increase in royalty fees and a decrease in access fees.

Net transaction fees for options were up $3.7 million in the second 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 $80.7 million, up $4.8 million or 6 percent. This increase reflects a 9 percent increase in ADV over last year's second quarter, led by ADV increases of 9 percent in SPX options and 15 percent in VIX options, offset somewhat by a 1 percent decrease in index RPC, primarily due to a mix shift.

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 second quarter. Total market share for CBOE Holdings was 42.2 percent for the second quarter of 2017, up from 38.7 percent in the second quarter of 2016, reflecting market share gains across each of our options exchanges on both a year-over-year and quarter-over-quarter comparison.

Moving to Futures, our fastest growing and highest RPC business segment posted record trading volume and ADV in the second quarter. CFE traded an average 307 thousand contracts per day for the quarter, fueling net revenue of $36.2 million, a 20 percent increase compared to the same quarter a year ago. This increase resulted from higher net transaction fees, driven by a 19 percent year-over-year increase in futures ADV and a 5 percent increase in RPC. Futures RPC for the quarter was $1.762 compared with $1.682 in last year's second quarter, primarily reflecting the impact of fee changes implemented in January of this year.

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 5 percent, driven by the strength of our proprietary products, particularly VIX futures and index options. On a combined basis, proprietary products accounted for 65.4 percent of net transaction fees in the second quarter of 2017 compared to 62.2 percent in the second quarter of 2016.

Turning to U.S. Equities, net revenue was up 3 percent primarily driven by increases in non-transaction revenue offset somewhat by lower net transaction fees. Our results reflect a 5 percent decline in market volumes and a 1.2 percentage point decrease in market share, offset by a 5 percent increase in net capture. We witnessed a continuation of low volatility during the second quarter, wherein generally, overall equities volumes decline as a higher percentage of shares are traded off-exchange. However, strong non-transaction revenue more than offset the shortfall in net transaction fees, with solid growth in exchange services and other fees and market data fees.

Conversely, market volumes for European equities were up 4 percent in the second quarter. In U.S. dollars, European equities reported net revenue of $18.5 million, an increase of 3 percent versus last year's second quarter, despite the weaker pounds. In local currency, net revenue actually grew 16 percent to 14.5 million pounds in the second-quarter 2017 from 12.5 million pounds in the second-quarter 2016, reflecting growth in both net transaction fees and non-transaction revenue. The increase in net transaction fees resulted from the increase in overall market average daily notional value (ADNV) and a 7 percent increase in net revenue capture.

For the second quarter of 2017, Bats retained its position as the largest European stock exchange with 21.3 percent market share.

Net revenues for Global FX rose 21 percent to $10.9 million in the second quarter of 2017. This increase was due to access fees implemented in the third quarter of 2016. In addition, market share increased from 11.5 percent in last year's second quarter to 12.9 percent, tying an all-time high also reached in the first quarter of this year.

During the second quarter of 2017 nearly $28 billion of average daily notional value traded on the Hotspot FX platform, up 8 percent from nearly $26 billion in last year's second quarter.

Turning to expenses, this next slide details total adjusted combined operating expenses of $101.3 million for the quarter, down $5.7 million or 5 percent compared with last year's second quarter. Looking at the expenses in detail, the favorable variances are mainly in professional fees and outside services and depreciation and amortization. The decrease in profession fees and outside services reflects the realization of synergies, which resulted in lower expenses for legal services, consulting fees, audit fees and other corporate-overhead. The decrease in depreciation and amortization primarily resulted from the acceleration of certain systems depreciation and amortization in 2016.

For the second quarter, we realized $7.1 million pre-tax in expense synergies, primarily seen in compensation and benefits and professional fees and outside services. We continue to make solid progress executing on our integration plans and as we noted on our last call, the realization of synergies is ahead of plan and we expect to end 2017 with $20 million in GAAP run-rate synergies and to achieve the $50 million run rate in year three. We look forward to updating you as we make further progress in the integration process.

Turning to guidance, looking at our expense guidance for the full-year 2017, we now expect to be at the low end of our guidance range of $415 to $423 million. Adjusted combined operating expenses in the third and fourth quarters are expected to increase somewhat compared to the second quarter, reflecting merit increases and higher costs for professional fees and outside services, driven in part by expected fees for the consolidated audit trail (CAT) to be incurred in the third and fourth quarters.

Moving to income taxes. Our effective tax rate on adjusted earnings for the second quarter was 36.2 percent, within our guidance range of 35 to 37 percent we provided on our last call. Looking ahead, as a result of corporate income tax law changes enacted in Illinois in early July, we now expect our effective tax rate on adjusted combined earnings for the full year to be in a range of 35.5 to 37.5 percent, resulting in an effective tax rate in the third and fourth quarters closer to the high end of our range. This guidance excludes a one-time charge we expect to take in the third quarter to re-measure our deferred tax positions, as well as other non-GAAP adjustments. The effective tax rate on GAAP earnings is expected to be in a range of 37 to 39 percent for the year.

In addition, we are reaffirming our guidance for depreciation and amortization and capital expenditures for the year, which projects increased cap ex spending in the back half of the year.

Now I'd like to turn it over to Brian to provide an update on our capital management.

Brian Schell, Deputy CFO

Thanks Alan.

We continue to take a balanced approach to our capital management that we believe results in long term shareholder value. As such, our capital allocation priorities have not changed. We plan to invest in the growth of our business, return capital through dividends and utilize excess cash to pay down our five-year term loan as quickly as possible.

Consistent with that philosophy, last week our Board declared a dividend for the third quarter and raised the third-quarter dividend by 8 percent, to $0.27 per share from $0.25 per share.

Our quarterly results once again generated strong cash flows, which enabled us to reduce our debt by an additional $75 million and still end the second quarter with adjusted cash and investments of $149 million.

During the quarter, we also completed an offering of $300 million of 2-year 1.95 percent senior notes. All of the net proceeds were used to pay down a portion of the five-year term loan. This transaction resulted in a compression of our interest rate spread and, by converting a portion of our debt from floating rate to fixed rate, reduced our interest rate exposure to possible future interest rate hikes.

Our debt to EBITDA ratio based on trailing twelve months adjusted combined EBITDA at quarter end was 2.1 times, which is down from 2.4 times at the end of the first quarter. And, while we don’t have a specific leverage ratio target we are currently managing to, we will look to continue to reduce our debt to enhance our balance sheet flexibility.

While we did not make any share repurchases in the second quarter, we may allocate capital to make opportunistic share repurchases, depending on the circumstances.

To summarize, during the second quarter we built on the strong momentum we experienced in the first quarter, and continued to 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 profitability margins
- An integration plan on track, with a strong cost synergy realization, and
- Ongoing focus on capital allocation by reducing debt and increasing our quarterly dividend

Overall, we are pleased with the progress we are making and are excited about the strength of our core business. We are committed to maintaining our focus on expense discipline and driving enhanced returns for our shareholders.

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. 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.

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

Cautionary Statements Regarding Forward-Looking Information:

This press release 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; price competition and consolidation in our industry; decreases in trading volumes, market data fees 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 and exposure to risk from third parties; 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 attract and retain skilled management and other personnel, including those experienced with post-acquisition integration; 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 and unauthorized disclosure of confidential information; challenges to our use of open source software code; our ability to meet our compliance obligations, including managing potential conflicts between our regulatory responsibilities and our for-profit status; damage to our reputation; the ability of our compliance and risk management methods to effectively monitor and manage our risks; our ability to manage our growth and strategic acquisitions or alliances effectively; unanticipated difficulties or expenditures relating to the acquisition of Bats Global Markets, Inc., including, without limitation, difficulties that result in the failure to realize expected synergies, accretion, efficiencies and cost savings from the acquisition within the expected time period (if at all), whether in connection with integration, migrating trading platforms, broadening distribution of product offerings or otherwise; restrictions imposed by our debt obligations; our ability to maintain an investment grade credit rating; potential difficulties in our migration of trading platforms and our ability to retain employees as a result of the acquisition; and the accuracy of our estimates and expectations. 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 we 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.