Cboe Global Markets, Inc.
Third Quarter 2017 Earnings Call - Prepared Remarks
Tuesday, November 7, 2017

Debbie Koopman, VP Investor Relations

Good morning and thank you for joining us for our third quarter earnings conference call. On the call today, Ed Tilly, our Chairman and CEO, will discuss the quarter and provide an update on our strategic initiatives. Then, Alan Dean, our Executive Vice President and CFO, will provide an overview of our third-quarter 2017 financial results and Brian Schell, our Deputy CFO, will review the quarterly results in more detail, including an update on certain guidance metrics. 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.

I am pleased to report on a strong third-quarter 2017 at Cboe Global Markets, with adjusted earnings per share of $0.89 on net revenue of $270 million, led by continued growth in our proprietary index products, with record ADV in VIX options and futures despite record low volatility.

Overall options average daily volume increased 11 percent in the third quarter compared to the previous year, and our proprietary products continued to outperform the industry. Index options volume increased 26 percent, driven by a record quarter in VIX options trading and continued strong trading in SPX options, which increased 56 percent and 12 percent, respectively. VIX futures trading set an all-time high for a second consecutive quarter, with ADV up 36 percent compared to the third quarter last year.

We saw third-quarter market share in both U.S. and European equities decrease against the prior year's third quarter, due to ongoing low volatility.

Global FX volume was up 13 percent and our market share was 12.9 percent for the third quarter, compared to 12.4 percent a year ago. We are preparing to launch trading of non-deliverable FX forward transactions (NDFs) in November. NDFs will trade on Cboe SEF.
The Cboe ETF Marketplace continued to grow in the third quarter, with 23 new ETF launches and a record 30 transfers on a single day from iShares, bringing our total ETP listings to 234 at the end of September. Year to date through September, we executed 22 percent of trades and captured 38 percent of all new listings and 62 percent of transfers. Our market share of all U.S. ETP listings now stands at 11 percent.

Before recapping the quarter's key initiatives, I will touch on our new company name, mission and commitments, which we unveiled on October 17. Our new name blends what many already informally called us, Cboe, with the extended global reach afforded us by the acquisition of Bats. Our mission, powering potential to stay ahead of an evolving marketplace, is fueled by our commitment to relentless product innovation, leading-edge technology, and seamless trading solutions.

Let's take a look at the past quarter through the lens of our three commitments.

Our commitment to driving growth through product innovation has never been greater, nor has our ability to bring new innovations to market. Our diversified product line allows us to shape every aspect of the product development cycle and our new asset classes represent new building blocks for innovation. Additionally, we continue to tap the potential of long-standing proprietary products, such as our flagship S&P 500 options franchise.

In September, we announced plans to launch options on 10 S&P Select Sector Indices designed to provide market exposure to widely followed U.S. equity sectors represented in the S&P 500. The new options will allow European investors who cannot currently hold options on ETFs due to certain European regulations to target U.S. equity exposure. We will leverage our extended reach in Europe to market Sector options, which we expect to launch by year end.

Our second commitment is to differentiating our company with leading-edge, state-of-the-art technology.

We expect the migration of Cboe exchanges onto Bats proprietary technology to maximize our value proposition for customers and shareholders alike and to form the foundation for our company's ongoing growth. Working closely with our customers is key to a seamless migration. In September we held our third conference call to update customers on the progress of our technology migration and their feedback remains positive.

The migration of the Cboe Futures Exchange to the Bats platform is progressing well and remains on track for our planned February 25, 2018 launch. The implementation of our new index platform is also on track for the first quarter of 2018. The new platform will serve as the foundation for our growing index business and enable us to better calculate and disseminate data for new and existing indices.

We are simultaneously preparing for the migration of C2 Options Exchange to Bats technology, which is planned for May 14, 2018. Preparations are also underway for the migration of the Cboe Options Exchange to the Bats platform. The first step will be migrating SPX options to the Hybrid system, which we are targeting for the second quarter of 2018.

On October 23, we successfully launched the EDGX Options Exchange Complex Order Book, designed to be the most efficient and adaptable complex order book in operation. We expect the new functionality to provide immediate benefits to EDGX customers and to form the foundation for all complex orders handled by Cboe Global Markets, once all of our exchanges migrate to Bats technology.

In other technology news, last week we announced our acquisition of Silexx, a developer and operator of a multi-asset order and execution management system (OEMS) that caters to institutional customers throughout the U.S. The Silexx platform supports equities, options and futures trading and provides access to roughly 40 global markets, including in Europe and Asia. We are pleased to provide customers with an additional, streamlined channel to industry-leading data, analytics and trade execution tools.

Our third commitment is to providing seamless trading solutions through a blend of data, analytics and navigational trading tools coupled with a distinctive emphasis on customer education and collaboration.

We view MiFID II, for example, as an opportunity to help customers navigate the changing regulatory environment with value-added products and services.

Our foremost goal was to provide our customers with operational readiness ahead of MiFID II with ample time to test their systems. I'm pleased to say we successfully completed our fourth and final software release, and that all exchange functionality needed for MiFID II compliance is now in place.

Our Large in Scale (LIS) block trading platform and our Periodic Auctions offering, a lit book operating auctions throughout the day, were developed in anticipation of the new volume caps under MiFID II, which are expected to limit trading in dark venues. Both were designed to enable investors to find liquidity and trade large quantities of stock with low market impact.

Our ability to provide market participants with cutting-edge trading solutions is supported by our ongoing commitment to customer collaboration and education. This commitment is highlighted by Cboe Risk Management Conferences (RMC), which are now held annually in the U.S., Europe and Asia. Most recently, we enjoyed record attendance at our sixth annual RMC Europe in September, held just outside London. RMC attendees, who are often early adopters of our new products and services, had the opportunity at RMC Europe to interact with team members who represent new product lines at Cboe, including FX products and European equities.

In closing, I would like thank our team for a great third quarter, our first quarter reporting as Cboe Global Markets. It is a credit to the entire team that we are now operating as one bigger, bolder company, just eight months after the close of our deal. Our integration work is not over, but there is an excitement throughout our company in seeing our ongoing efforts come together. Every team member has been integral to the creation of Cboe Global Markets, a truly transformational step in the great history of our company. The collective effort of our team has positioned us to power the potential of our customers and shareholders in the quarters and years ahead.

With that, I thank you for your time. Before turning this over to Alan for the last time, I would like to thank him for his outstanding contribution to our company. As you know, Alan will be retiring after 38 years of service to Cboe. He helped successfully guide Cboe through major challenges, including the aftermath of the Market Crash of 1987, our transition from floor to electronic trading, and our journey from a membership organization to a shareholder-based company. He was instrumental in the accomplishment of major milestones, including our successful IPO in the midst of a very challenging financial environment, our transformative deal with Bats and our ascent to an S&P 500 company. More important, in between those major events, Alan lent his guidance, wise counsel and steadfast support to Cboe on a daily basis for the past 38 years. I thank him for his dedication, service and friendship.

Alan Dean, CFO

Thanks Ed and good morning. Before I begin I'd like to thank all of you on the call - analysts, portfolio managers, and shareholders for your support over the years. As CFO of Cboe, one of the reasons I've enjoyed my job so much is that I have had the opportunity to interact with so many consummate professionals. It has been a pleasure to work with all of you. Lastly, as I ride off into the sunset, I know that Cboe is in good hands with Ed, Chris and of course with Brian Schell at the financial helm. Now onto the quarter.

Before I begin, let me point out that our third-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, our third quarter financial review 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, we posted another strong quarter, primarily driven by the continued strength of our proprietary index products along with continued growth in non-transaction revenue, against the backdrop of record low market volatility and a decline in U.S. equities trading and relatively flat options trading activity industry-wide in the third quarter 2017 compared with the same period in 2016.

I will give a quick snapshot of the quarter then turn it over to Brian to dive deeper into the quarterly results. Our adjusted combined net revenue was nearly $270 million, up 10 percent above last year's third quarter. Adjusted operating expenses of $101.9 million were down 2 percent and the adjusted operating margin increased 440 basis points to 62.2 percent. Adjusted diluted earnings per share of $0.89 rose 24 percent over 2016's third quarter. Now I'll turn it over to Brian.

Brian Schell, Deputy CFO

Thank you Alan. And let me say that I am honored to succeed you and thank you for our partnership over these past twelve months. I look forward to continuing to work with the investor/analyst community as well as with the Cboe team as we further our efforts to create long-term value for all of our stakeholders and strive to capitalize upon the significant opportunities that lie ahead of us – as demonstrated by our results reported today. Now let's review the quarter in more detail.

Looking at our results further, starting with net revenue, the key growth driver during the quarter was net transaction fees and to a lesser extent increases in other revenue, market data revenue and exchange services and other fees. These increases were offset somewhat by higher royalty fees and lower regulatory fees. The decrease in regulatory fees primarily reflects lower regulatory costs we are incurring, resulting in a reduction in the fees we record to cover some of these costs. We've seen this line item steadily decline this year and believe the third quarter regulatory fees represent a good run rate to use for building expectations going forward.

Looking at the revenue contribution by business segment, we achieved higher revenue across each business segment, except U.S Equities, with options and futures contributing the largest revenue increases.

In our options segment, net revenue of $130.7 million was up $11.5 million, or 10 percent, compared with last year's adjusted combined net revenue for the third quarter. The increase was primarily driven by higher revenue from net transaction fees, offset somewhat by an increase in royalty fees.

Net transaction fees for options were up $13.8 million or 15 percent in the third quarter, with higher revenue from index options as well as multiply-listed options. Net transaction fees from our higher-RPC index options of $87.0 million were up $12.9 million or 17 percent. This reflects a 26 percent increase in ADV, led by increases of 12 percent in SPX options and 56 percent in VIX options, offset somewhat by a 5 percent decrease in index options RPC, primarily due to a mix shift and higher volume discounts.

Total market share for Cboe's U.S. options exchanges was 41.7 percent for the quarter, up 2.3 percentage points compared to our combined market share in the third quarter of 2016. The higher market share contributed to growth in market data revenue, with increases in revenue from both industry and proprietary market data.

Moving to Futures - our fastest growing and highest RPC business segment - posted record ADV for the second consecutive quarter. Net revenue of $38.9 million was 37 percent above last year's comparable quarter. This increase was driven by a 36 percent increase in futures ADV and a 3 percent increase in RPC. The RPC increase primarily reflects the impact of fee changes implemented in January of this year.

Looking at Cboe’s organic growth, which excludes the legacy Bats revenue contribution, we saw strong organic growth of 15 percent for the quarter, primarily due to our proprietary products, particularly VIX futures and VIX options. On a combined basis, proprietary products accounted for 68.8 percent of net transaction fees this year compared to 63.9 percent last year.

Turning to U.S. Equities, net revenue was down slightly primarily driven by lower net transaction fees, which were nearly offset by growth in non-transaction revenue. The results reflect an 8 percent decline in market volumes and a 1.6 percentage point decrease in market share, with net capture unchanged. We witnessed another quarter of low volatility, which typically results in lower overall equities volumes and a higher percentage of volume traded off-exchange. As noted previously, continued growth in non-transaction revenue nearly offset the shortfall in net transaction fees, with solid growth in exchange services and other fees and proprietary market data fees. We continue to see positive customer response to our proprietary market data offerings, which had revenue growth of 41 percent in the quarter, with approximately 20 percent of the growth coming from new customers or additional sales to existing customers and the remainder from pricing changes. We are encouraged by the market response to our market data offerings and look forward to further expanding our customer base.

Market volumes for European equities were up 3 percent in the quarter. Net revenue for European Equities increased 16 percent on both a dollar and local currency basis versus last year's third quarter, reflecting growth in net transaction fees and non-transaction revenue. The increase in net transaction fees primarily resulted from an 8 percent increase in net capture, offset somewhat by a 1.9 percentage point decline in market share.

Net revenue for Global FX rose 9 percent to $11.3 million. This increase was driven by higher transaction fees, reflecting a 13 percent increase in average daily notional value traded on the Cboe FX platform, offset somewhat by a 3 percent decline in the net capture. And our market share increased 50 basis points to 12.9 percent.

Turning to expenses, this next slide details total adjusted operating expenses of $101.9 million for the quarter, down $1.5 million or 2 percent compared with last year's adjusted combined expenses for the third quarter. Looking at the detail, the favorable variances are driven by reductions in compensation and benefits, professional fees and outside services, and depreciation and amortization. The declines primarily reflect the realization of synergies, which resulted in a reduction in staffing and lower expenses for legal services, consulting fees, audit fees and other corporate-wide overhead.

For the third quarter, we realized $7.6 million pre-tax in expense synergies, primarily seen in compensation and benefits and professional fees and outside services. Our realization of synergies is running ahead of plan and as a result we now expect to end the year with approximately $30 million in GAAP run-rate synergies for 2017; however, at this time we believe we have just pulled some of the savings forward and as a result are not changing our forecast of synergies to be realized in the longer term.

We look forward to providing you with further updates as our integration progresses.

Looking at our expense guidance for the full-year 2017, we now expect adjusted operating expenses to be in a range of $413 to $415 million, reflecting a reduction from our original range of $415 to $423 million.

Moving to income taxes. Our effective tax rate on adjusted earnings for the third quarter was 36.2 percent, within the guidance range of 35.5 to 37.5 percent we provided on our last call. This excludes a one-time charge of $7.4 million recognized in the third quarter to re-measure our deferred tax positions, as well as other non-GAAP adjustments.

We now expect the effective tax rate on GAAP earnings for the year to be in a range of 37.5 to 38.5 percent compared with prior guidance of 37 to 39 percent. The effective tax rate on adjusted combined earnings is expected to be in a range of 36 to 37 percent for the full year and a range of 37 to 38 percent for the fourth quarter. The tax rate guidance incorporates the impact of the corporate income tax law changes enacted in Illinois in early July. Looking out to 2018, we expect the effective tax rate to increase compared with 2017, reflecting the full year impact of the Illinois tax rate changes.

In addition, we now expect capital expenditures for the year to be in a range of $49 to $53 million versus our previous guidance of $55 to $60 million, reflecting better visibility on our project costs and timing as we enter the fourth quarter. We also reaffirmed our guidance for depreciation and amortization.

Turning to capital allocation, we continue to focus on allocating capital in the most efficient manner to create long-term shareholder value. As such, we prioritize capital by investing in the growth of our business, returning capital through dividends and utilizing excess cash to pay down our debt as quickly as possible.

Our quarterly results once again generated strong cash flows, which enabled us to reduce our debt by an additional $100 million and payout dividends of $30.6 million, while still ending the third quarter with adjusted cash and investments of $127 million.

Our debt to EBITDA ratio based on trailing twelve months adjusted combined EBITDA at quarter end was 1.9 times, down .2 turns from the second quarter and roughly a half turn since 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 de-lever to enhance our balance sheet flexibility.

While we did not make any share repurchases in the third quarter, we remain open to allocating capital to make opportunistic share repurchases, depending on the circumstances.

To summarize, during the third quarter we built on the strong momentum we have experienced throughout the year, and continued to demonstrate:

- Our focus on and the strength of our proprietary index products, generating strong organic growth
- Diversifying and stabilizing our revenue streams with a growing base of non-transaction revenue
- Disciplined expense management
- Leveraging the scale of our business model, producing higher profitability margins
- An integration plan on track, with improved cost synergy realization, and
- Ongoing focus on capital allocation by reducing debt while continuing to return capital to shareholders though quarterly dividends

In closing, we are uniquely positioned with solid market fundamentals and exciting innovative products and services in our pipeline, which we believe will power our potential to serve the needs of our customers and build shareholder value.

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 queue and if time permits we'll take a third 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.