Cboe Global Markets, Inc.
Fourth Quarter 2017 Earnings Call - Prepared Remarks
Friday, February 9, 2018

Debbie Koopman

Good morning and thank you for joining us for our fourth 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, Brian Schell, our Executive Vice President and CFO, will provide an overview of our fourth-quarter 2017 financial results and guidance for certain financial metrics for 2018. 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 and review of our business.

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

Ed Tilly, Chairman & CEO

Good morning.

I know many of you joined us for our call on Wednesday. Thank you for joining us again today.

I am pleased to report on a strong fourth quarter 2017 at Cboe Global Markets.

As we approach the one year anniversary of our acquisition of Bats Global Markets, I am gratified to report that we accomplished what we set out do within the first year: chiefly, to integrate two great teams while continuing to serve our customers with superior products and services and to grow our respective business lines.

A strong fourth quarter capped off a year of tremendous growth, including:

- An increase in total options ADV of 11 percent on a combined company basis, outpacing the 4 percent gain made by the industry overall.

- New record trading volume in VIX options and futures, with each increasing 23 percent over the previous year.

- An all-time high in SPX Weeklys trading, which drove another record year in SPX trading.

- An 82 percent increase in ETP listings, bringing our total number to 250 at year's end, with a market share of 12 percent.

- Record trading on our LIS platform, now one of the largest block trading facilities in Europe.

- Record Cboe FX market share and ADNV fueled by increased use of our London matching engine.

Our ability to deliver superior results across key business lines in 2017, while making great strides in our integration with Bats, positions us to more fully leverage our increased global reach and expanded product line. Our mission, to power potential to stay ahead of an evolving marketplace, is fueled by our commitment to relentless product innovation, leading-edge technology, and seamless trading solutions. I'll take a minute here to look at our recent progress in those three key areas.

Our commitment to driving growth through product innovation was evidenced by our December 10th launch of Cboe bitcoin futures (XBT), the world's first exchange-listed, regulated bitcoin futures product. We are encouraged by the early trading in XBT futures, which continues to steadily build in an efficient, transparent and orderly marketplace. At the time of our first XBT settlement auction on January 17, over 124,000 contracts had traded, representing a notional value of over $1.5 billion. Moreover, the successful settlement process worked exactly as designed.

The migration of the Cboe exchanges onto Bats proprietary technology is central to our commitment to providing customers with superior trading technology. We expect the migration to maximize our value proposition and to power our company's ongoing growth.

Working closely with our customers is key. We held our fourth conference call with customers in December, and their feedback remains positive.

The migration of the Cboe Futures Exchange to Bats technology remains on track for February 25, 2018. We are simultaneously preparing for the migration of C2 Options Exchange, planned for May 14, 2018.

I'm pleased to add that we successfully launched our new index platform on January 22nd. The new platform serves as the foundation for our growing index business and enables us to better calculate and disseminate data for new and existing indices.

We are committed to enhancing the customer's trading experience through regulatory advocacy, new technologies, and education.

We continue to work on behalf of our customers by vigorously advocating for the SEC's approval of the Cboe Market Close (CMC) auction, a closing match process for non-Cboe securities. We created CMC as a competitive alternative and were encouraged by the approval of our proposal by SEC staff on January 17th. The subsequent appeals by competitors will delay the benefits we believe CMC can deliver to investors in U.S. equity markets, but we continue to work proactively with the SEC on a favorable resolution.

We made inroads recently on behalf of our customers by seeking and receiving permission from Japan and Hong Kong regulators to add Cboe Global Markets' U.S. Equities to their respective lists of approved exchanges. These designations are expected to increase global access to our growing ETF listings business.

We viewed our preparations for MiFID II as an opportunity to help customers navigate the changing regulatory environment in Europe with value-added products and services. We have already seen an uptake in volume in our new product offerings that, while still a small piece of our overall European business, is encouraging given these are very early days.

It is a credit to our entire team that we were able to deliver superior results throughout the year, while also successfully combining two strong companies into one even greater company. As a result, we are well positioned to continue to execute on our growth initiatives, including:

- Growing our proprietary products
- Expanding our global reach across asset classes
- Migrating our exchanges to Bats to technology
- And achieving our acquisition synergy targets

With that, I will now turn it over to Brian.

Brian Schell

Thanks Ed and good morning.

Before I begin, I want to remind everyone that unless specifically noted, my comments relate to fourth quarter 2017 as compared to the prior-year period and are based on our non-GAAP adjusted combined results including Bats. On that basis, our fourth quarter results followed the same general theme you've heard from us throughout 2017, with solid financial results primarily driven by:

- the continued strength of our proprietary index products - against the backdrop of low market volatility,
- growth in non-transaction revenue,
- expense discipline coupled with the overachievement of expense synergies,
- and all of that leading to margin expansion and earnings growth.

Summarizing our combined results for fourth quarter 2017 versus 2016:

- We continued to grow net revenue, posting a 7 percent increase in combined net revenue, with increases across each business segment.

- Our options and futures segments contributed the largest revenue gains, which drove organic growth of 8 percent for the quarter and 9 for the full year.
- We held operating expenses relatively flat for the quarter, which combined with our revenue growth, resulted in a 260 basis points improvement in our adjusted operating margin and a 90 basis points lift in our adjusted EBITDA margin
- Adjusted diluted earnings per share of $0.87, up 12 percent,
- And lastly, given the tax reform legislation passed in December, we revalued our deferred tax liability and recorded a one-time tax benefit of approximately $192 million, or $1.70 per diluted share, in the fourth quarter, which is included in our non-GAAP adjustments. More to come later on the impact of tax reform.

The press release we issued this morning and our slide deck provide the key operating metrics on volume and revenue capture for each of our segments as well as an overview of key revenue variances. At this point, I'd like to highlight some of the key drivers influencing our performance in each segment.

In our options segment, the 3 percent increase in net revenue was driven by higher net transaction fees, offset somewhat by lower regulatory fees and an increase in royalty payments.

The increase in royalties was due to higher volume in our licensed index products as well a mix shift between index products traded. The decline in regulatory fees primarily reflects lower regulatory costs. Earlier this month, we lowered our options regulatory fee and expect 2018's regulatory revenue to be about 12 to 13 percent below 2017's full-year net regulatory revenue of $32.0 million. However, given that revenues from regulatory fees must be used for regulatory costs, this should have no impact on our bottom line in 2018.

As Ed noted, we remain focused on growing our proprietary products, as we did in 2017 with the delivery of record volume in both SPX and VIX options. In 2018, we plan to continue to focus our efforts on growing our proprietary index products with ongoing education, business development and various incentive programs, such as those aimed at large over the counter trades and retail volumes. While the incentive programs may put some pressure on RPC, we expect the overall impact to be net positive.

Turning to futures, we had another record year, with growth in both contract volume and RPC – with the latter reflecting a modification to our day trade fee program, which had a favorable impact on RPC for the fourth quarter and the entire year. For 2018, we continue to be optimistic about a successful technology migration later this month, which we believe will have a positive impact on trading as we provide CFE market participants with enhanced trading tools and a better trading experience.

Turning to U.S. Equities, net revenue was up slightly driven by growth in non-transaction revenue, partially offset by lower net transaction fees. The continued low volatility levels in fourth quarter of 2017 produced lower overall equities volumes and a higher percentage of volume traded off-exchange.

As this slide shows, our SIP market data revenue was flat year over year for the quarter and full year, with proprietary market data accounting for nearly all of the market data revenue gains. Our proprietary market data revenue saw growth of 39 percent in the quarter and 24 percent for the year, with approximately a fourth of each coming from new customers or additional sales to existing customers and the remainder from pricing changes. While we expect continued growth in proprietary market data in 2018, we also expect to see additional downward pressure on the SIP revenue due to industry consolidation and the impact of off-exchange trading.

Net revenue for European Equities increased 17 percent on a U.S. dollar basis, reflecting growth in net transaction fees and non-transaction revenue as well as benefiting from the strength of the pound sterling versus the U.S. dollar. On a local currency basis, net revenue increased 10 percent.

And as Ed noted, our focus for European Equities has been to be ready, day one, with a full suite of products and services that address the new requirements of MiFID II. We look forward to building on the early success we are experiencing under this new regulatory regime.

Net revenue for Global FX showed steady progress this year and the fourth quarter marked a high point for the year in both market share and average daily notional value traded on the Cboe FX platform. Much of the growth was driven by the increased volumes on our London matching engine and better overall fill rates. We plan to focus our efforts on continuing to grow the core spot FX offering, while also diversifying our revenues with new products, and expanding our market data offerings.

Turning to expenses, total adjusted operating expenses of $105 million for the quarter were relatively flat compared with the prior year and in line with our guidance. Looking at the key expense variances, the increase in compensation and benefits reflects higher incentive-based compensation, aligned with our financial and operational performance and the increase in travel and promotional expenses reflects additional marketing-related expenses. The decline in professional fees and outside services primarily reflects the realization of synergies.

For the fourth quarter and full year 2017, we realized $7.5 million and $24.6 million in pre-tax expense synergies, respectively, primarily from compensation and benefits and professional fees and outside services. We ended 2017 with approximately $33 million in GAAP run-rate synergies. In 2018, we are forecasting incremental run-rate expense synergies of $17 million for a total of $50 million. Most of the synergy increase relative to 2017 is expected to come from IT-related expenses. And while the projected 2018 run rate is equivalent to the run rate we originally expected for 2019 – reflecting an earlier realization of expense savings than originally planned – it is still too early to revise our long term synergy forecast. Keep in mind, the projected run-rate expense synergies for our technology migrations are heavily weighted toward our largest and most complex exchange, C1 (Cboe Options).

As stated on previous calls, we plan to provide further guidance on a target date for the C1 (Cboe Options) technology migration after we complete the CFE technology migration. And once we complete the technology migration of C2 in May, we expect to be in a better position to make any revisions to our longer-term expense synergy run-rate forecast.

Looking at our expense guidance for the full-year 2018, we expect adjusted operating expenses to be in a range of $420 to $428 million, reflecting our expectation for expenses to be up 1 to 3 percent versus 2017. Note that this guidance includes approximately $8 million, or 2% of 2017 adjusted operating expenses, for incremental expenses primarily associated with the recent Silexx acquisition, the increased strength of the pound sterling and OPRA-related expenses that will have an offsetting benefit in our net revenues.

Turning to depreciation and amortization expense, which is included in our total expense guidance is expected to be $53 to $58 million, which excludes amortization of acquired intangible assets of about $157 million and will be excluded from our non-GAAP results.

Lastly, capital spending in 2018 is expected to range from $50 to $55 million, which includes our investment to migrate the Cboe futures and options exchanges onto proprietary Bats technology, as well as the ongoing investment in technology and software to support Cboe's current trading platform.

Now I'd like to spend some time on income taxes. Like most U.S. companies, our current and future results are impacted by the recently enacted U.S. corporate tax reform. Consequently, our fourth quarter results included a one-time benefit of $192 million from the re-measurement of our deferred tax positions. However, our effective tax rate on adjusted earnings for the fourth quarter was approximately 37.0 percent, again, within the guidance range we provided on our last call.

Looking further at the impact of tax reform on 2018, and given the predominance of our U.S. earnings contribution, we expect to see a significant reduction in our overall corporate tax rate, driven primarily by the reduction in Cboe's statutory corporate tax rate from 35% to 21%. However, the new tax law both repeals a number deductions relevant to Cboe, most notably the domestic production activities deduction (also referred to as Section 199) and the deductibility of certain other expenses, and introduces incremental taxes on foreign earnings.

We expect the effective tax rate on adjusted earnings to be in a range of 26.5 percent to 28.5 percent. This tax rate guidance reflects the net impact of the corporate tax reform and a full year of the Illinois tax rate increase enacted in July of 2017, resulting in an expected total net reduction in our effective tax rate in the range of 8 to 10 percentage points.

Turning to capital allocation, we remain focused on allocating capital in the most efficient manner to create long-term shareholder value. While the reduction in the corporate tax rate is expected to increase our earnings and provide additional cash, our capital allocation priorities have not changed. We plan to continue to invest in the growth of our business, return capital through dividends with a goal of steady annual increases, pay down our debt and evaluate share repurchases.

Our quarterly results once again generated strong cash flows, which enabled us to reduce our debt by an additional $75 million and payout dividends of nearly $31 million, while still ending the year with adjusted cash and investments of $120 million, and a leverage ratio of 1.8 times.

To summarize, during the fourth quarter we built on the strong momentum we experienced throughout 2017, and continued to demonstrate:

- Our focus on and the strength of our proprietary index products, resulting in 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 expense synergy realization, and
- Ongoing focus on capital allocation by reducing debt while continuing to return capital to shareholders though quarterly dividends

With that, I will turn it back over to Ed.

Ed Tilly, Chairman & CEO

Before opening it up for Q&A, I'd like to take a moment to provide follow up on the two areas of most interest to you on our call Wednesday: the percentage of VIX futures tied to ETP trading, both long and short, and who is trading VIX futures.

This first slide shows average AUM on a quarterly basis for the top long and short VIX-linked ETPs, which represent roughly 90 percent of VIX ETP assets, as relatively flat between Q4 2015 and January of 2018. During that same period, overall VIX futures ADV increased by 82 percent. So, while ETP assets continue to be important, the growth in VIX futures trading is no longer reliant on ETP activity.

This next slide demonstrates how our efforts to educate and grow our user base have increased the number of unique user accounts associated with trading on CFE, from 4,495 in Q4 2015 to 5,706 in Q4 2017, representing an increase of 27%. User accounts encompass broad range of market participants, including asset managers, dealers, market makers, proprietary traders and brokerage execution professionals. During this period, growth from overseas users interested in accessing our ETH only session has been particularly strong, with these user accounts up 57%.

As we mentioned Wednesday, the activity we see from issuers of XIV and SVXY is less than 5 percent of all VIX futures trading, representing ADV of about 12,000 contracts. It's important to note that non-institutional holders of these ETPs in the last reported period represented approximately just 21 percent of total holdings, with the remainder consisting of sophisticated institutional users who employ inverse VIX ETPs as part of a diverse mix of trading and investing strategies.

I thank you again for your time – both today and Wednesday. We continue to make volatility trading a primary educational focus. The growth in VIX futures and options trading is a result of the utility of these products under virtually any market condition. We see every change in market conditions as an opportunity to redouble our educational efforts. With that I will turn it over to Debbie, for instructions on the Q&A portion of the call.

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.