Cboe Global Markets, Inc.
First Quarter 2018 Earnings Call - Prepared Remarks
Friday, May 4, 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 first-quarter 2018 financial results and updated guidance for certain financial 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. Also note that references made to the planned migrations of C2 Options Exchange and the Cboe Options Exchange are subject to regulatory review.

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 2017, 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, CEO

Good morning and thank you for joining us today.

I am pleased to report that first-quarter 2018 was our best quarter ever and that we raised our expected run-rate expense synergy target to $85 million at the end of 2020, up $20 million and a year ahead of our initial projections. Brian will discuss that in more detail later. Cboe Global Markets reported adjusted earnings per share of $1.38 on net revenue of $329 million, led by double-digit, year-over-year gains across each of our business lines and new trading highs in our proprietary products.

Our record results underscore the utility of our products and the strength of our diversified portfolio of exchanges, particularly in times of heightened market volatility, which we saw during the first quarter.

As we shared in previous calls, we expected that the ongoing growth we saw in VIX and SPX options and VIX futures during sustained periods of low volatility would spike when volatility returned to the market. This expectation played out in the first quarter in the form of new quarterly volume records in VIX futures and options and SPX options, as well as a lift to our equities and FX businesses.

Following a sustained period of record low volatility in 2017, in which the VIX Index averaged just over 11, compared to its long-term average of 19, investor perceptions of risk changed dramatically in Q1, marked by large spikes in both implied and realized volatility. The "new normal" appears to be a VIX level ranging between 15 and 25, which is more in line with historical levels than what we saw throughout 2017.

Historically, transitions from low to high volatility regimes result in traders re-assessing the products they use and shifting into products that are best suited to a new market environment. We believe that small differences between front month and longer dated VIX futures - that is, a "flat" VIX futures term structure - is signaling that the market is still adjusting to the new volatility regime.

We view shifts in product usage as normal during these transition periods, and we believe we are seeing the shift play out within our proprietary index complex. While higher volatility is generally good for all our businesses, the flat VIX futures term structure has been a headwind for VIX trades that seek to capture price differences across the VIX futures curve. At the same time, large daily moves in the S&P 500 have created new opportunities for SPX option users who can capitalize on daily trading ranges that are three times greater than in Q4 2017. As such, ADV in SPX options in April was up 20 percent year-over-year compared to April 2017, and largely offset declines in VIX futures and options volume relative to last year's solid April trading. Furthermore, SPX ADV in April was 15 percent above SPX options activity for the full-year 2017.

Since early February, the VIX futures term structure has been flat or downward-sloping 55 of 61 days, an unusually long period not seen since 2011. However, we expect that VIX futures prices will eventually return to a more familiar upward-sloping pattern, as it has done in the past, regardless of where the market sets the new floor for equity volatility. Let me be clear, volatility is alive and well, and we are confident that our SPX and VIX products offer the trading tools to manage risk in any market environment.

Regardless of market conditions, we remain intensely focused on our commitments to product innovation, leading-edge technology and seamless trading solutions. I'll take a few moments here to provide an update on key strategic initiatives supporting those commitments.

Our legacy of driving growth through product innovation was highlighted throughout the month of April, which we proclaimed VIX month in commemoration of the 25th anniversary of the dissemination of the VIX. The month featured a daily VIX social media campaign, the launch of a new VIX website and a VIX symposium held for press and customers. Perhaps most fitting, we also announced a new VIX product.

On April 17 we launched the dissemination of the Cboe One-Year Volatility Index, which provides up-to-the-minute market estimates of one-year volatility. The one-year index was designed to monitor the market's expectations for longer-term volatility, which we expect will be especially useful for investors with longer-duration liabilities, such as insurance companies and pension funds. We are exploring the development of a futures contract on the Index, subject to regulatory review, and look forward to reporting on that going forward.

Turning now to the migration of Cboe exchanges onto Bats proprietary technology, which we believe will maximize our value proposition for customers and shareholders and power our company's ongoing growth.

We completed a major milestone of the integration with the flawless migration of Cboe Futures Exchange (CFE) to our Bats technology, as scheduled, on February 25. The migration provides our futures customers with a more efficient and user-friendly trading experience that includes greater bandwidth, significant latency reduction, enhanced risk controls and improved complex order handling.

We remain laser focused on executing a seamless technical and operational integration for all of our exchange platforms. We are well on track for our planned C2 Options Exchange migration on May 14, 2018 and, as announced last month, we have targeted October 7, 2019 for the migration of Cboe Options Exchange.

We are modifying Bats technology to incorporate both electronic and open outcry trading for Cboe Options Exchange, which includes SPX and VIX options trading. We targeted two technology enhancements for 2018 in advance of migrating Cboe Options exchange: the migration of S&P 500 Index options to Hybrid trading, which we successfully completed last week, and the introduction of new trading floor terminals, which we plan to begin rolling out on November 5, 2018, subject to regulatory review. We are encouraged by the initial response to SPX on hybrid and are very pleased that the conversion itself was flawless.

The completion of the CFE migration and significant steps taken to prepare for the C2 and Cboe Options migrations leave us well positioned to achieve our ultimate goal of providing our customers with a unified world-class trading experience on Bats leading edge technology across all our equities, options and futures markets.

As noted in our last call, our preparations ahead of MiFID II, which came into effect on January 3rd, have enabled us to grow our European business in the midst of the changing regulatory landscape.

The rapid adoption of our Periodic Auctions book this quarter, which is a MiFID II-compliant lit order book operating auctions throughout the day, demonstrates that market participants are finding value in executing their trades in a venue designed to provide minimal market impact. Our Large in Scale (LIS) block trading platform also continues to attract new customers and increase volume, with average trade sizes in excess of €1 million. Additionally, we've continued to grow our Systematic Internaliser technology services business, further diversifying our European business model.

While the liquidity landscape will continue to evolve under MiFID II, we believe our seamless rollout of new technology and services ahead of the new regulation leave us well-positioned to continue to adapt and grow.

In closing, I would like thank our team for a truly tremendous quarter. While the return of volatility to the marketplace provided great headwinds, the collective work of our team helped position each of our exchanges to benefit with double-digit volume increases. Further, throughout what proved to be our company's busiest quarter on record, we continued to lay the groundwork for future growth by rolling out new products and services while advancing our technology integration. As a result, I look forward to all that we can accomplish to power the potential of our customers and shareholders in the months and years ahead.

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

Brian Schell, CFO

Thanks Ed. And good morning, everyone.

Before I begin, I want to remind everyone that unless specifically noted, my comments relate to 1Q18 as compared to 1Q17 and are based on our non-GAAP adjusted combined results including Bats. Building on 2017's positive momentum, as Ed already noted, we reported record financial results for the quarter. In summary:

- Our net revenue grew 24%, with:
  - net transaction fees up 36%;
  - non-transaction revenue up 7%; and
  - organic net revenue growth of 28% for the quarter.

- Adjusted operating expenses increased 3%, which combined with our strong revenue growth, produced a 560 basis point lift in our adjusted EBITDA margin of 70.4%, demonstrating our strong operating leverage.

- And finally, our adjusted diluted earnings per share grew 47% to $1.38.

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. Additional disclosures can also be found in our Form 10-Q filed this morning. At this point, I'd like to briefly highlight some of the key drivers influencing our performance in each segment.

In our options segment, the 24% net revenue growth was primarily driven by higher net transaction fees, reflecting the record volumes previously noted.

Turning to futures, the 47% increase in net revenue resulted from a 44% increase in average daily volume (ADV) offset somewhat by a 5% decline in RPC – with the latter reflecting higher rebates related to the elevated VIX futures trading volume. We continue to be excited about the opportunities we believe the CFE technology migration will have for our futures business – in particular, allowing us to bring new products to market at a faster pace and more efficiently.

Overall, the long term growth of our proprietary products remains our primary focus and we have a robust pipeline of new products we are excited about launching.

Turning to U.S. Equities, net revenue grew 10%, with equities volume benefiting from the return of volatility to the market, shifting more trading to on-exchange venues versus off-exchange.

As this slide shows, total market data revenue for U.S. equities was up 16% in the first quarter, with SIP market data revenue up 14% and proprietary market data up 24%. However, a significant portion of the $3.7 million increase in SIP revenue was due to audit recoveries, so first quarter is not representative of our expectations for future quarters this year, as we continue to expect downward pressure on SIP market data due to industry consolidation. Looking at the growth in our proprietary market data revenue, the majority came from pricing changes implemented at the beginning of the year. We expect continued growth in proprietary market data in 2018 as we benefit from pricing changes and customer response to our Cboe One product.

Net revenue for European Equities grew 37% on a U.S. dollar basis, reflecting growth in both net transaction and non-transaction revenues, following the implementation of MiFID II in January, as well as strength of the pound sterling versus the U.S. dollar. On a local currency basis, net revenue increased a very healthy 18%. While we benefited from increased market volumes, we realized increased revenues from a higher net capture due to the later than planned implementation of the dark pool volume caps. We expect net capture to moderate back to historical levels for the remainder of the year.

Net revenue for Global FX grew 35% this quarter, setting new highs in both market share and average daily notional value traded on our platform. Volumes improved on both our New York and London matching engines, with the latter more than tripling its volumes year-over-year.

Macro environmental factors have certainly contributed to the overall growth in the spot FX market, but we believe our market share growth reflects the impact of technology enhancements as well as more effective liquidity provisioning.

Turning to expenses, total adjusted operating expenses were nearly $110 million for the quarter, up 3% compared with last year's first quarter. The key expense variance was in compensation and benefits, resulting from (1) higher incentive-based compensation – driven by, and aligned with, our financial and operational performance; and (2) accelerated stock-based compensation recognized in the first quarter, up about $4 million and $2.5 million, respectively.

As we pointed out on our last earnings call, there are several incremental expenses impacting our year-over-year comparability, such as expenses associated with the Silexx acquisition, the increased strength of the pound sterling and the gross-up of OPRA-related expenses. Additionally, during the first quarter we raised our capitalization threshold, which resulted in incremental expense. In total, these items accounted for about $2.9 million in incremental expenses this quarter, with the currency impact being the largest. If you adjust for those items, expenses would be up less than one half of a percent.

We are reconfirming our full-year expense guidance to be in the range of $420 to $428 million. We expect compensation and benefits to be lower in subsequent quarters, reflecting the expected realization of expense synergies as well as smoothing out of the impact from the accelerated vesting, which is typically weighted to the first quarter when new grants are issued.

For the first quarter we realized $3 million in pre-tax expense synergies, primarily from compensation and benefits.

As Ed mentioned, we established our technology migration date for C1, our final and most significant migration to Bats technology. With that key date now established, we raised our expected annualized run-rate expense synergy target to $85 million from $65 million. Furthermore, we now expect to reach this run-rate in 2020 - - a year earlier than our initial projections. We still expect to exit 2018 with approximately $50 million in annual run-rate expense synergies and now expect to reach $80 million at the end of 2019.

Turing to income taxes, our effective tax rate on adjusted earnings for the quarter was approximately 26%, somewhat below our annual guidance range of 26.5% to 28.5%, due to the settlement of uncertain tax positions during the quarter.

The effective tax rate on combined adjusted earnings in the first quarter of 2017 was 28.1%. The decline primarily reflects the favorable impact of corporate tax reform.

We are reaffirming that we expect the annual effective tax rate on adjusted earnings to be in a range of 26.5% to 28.5% for 2018, with the tax rate for the second quarter expected to be slightly above the high end of the guidance range and the tax rate for the third and fourth quarters expected to be at the higher end, but within, our guidance range.

In addition, we are lowering our guidance for capital expenditures to be $45 to $50 million, versus our previous guidance of $50 to $55 million. The decrease reflects more efficient spending and the adjustment of our capitalization threshold.

Moving to capital allocation, we are maintaining our unwavering focus on effective capital deployment to drive shareholder value by prioritizing the investment in our business to support our growth strategies; and then returning excess free cash flow to shareholders via a combination of dividends and share repurchases, while continuing to de-lever to maintain a strong balance sheet and longer term financial flexibility.

Our quarterly results once again generated strong cash flows, which enabled us to payout dividends of $31 million, use $44 million to repurchase shares and reduce our debt by an additional $25 million. Year-to-date through April 30th, we have repurchased approximately 451 thousand shares of Cboe common stock for about $51 million, or about $112 per share.

We ended the quarter with adjusted cash and investments of $166 million and a leverage ratio of 1.6 times. The adjusted cash balance was higher than normal due to a number of significant tax-related liabilities due in April.

In summary, Cboe delivered outstanding quarterly results and continued to demonstrate:

- Our focus on, and the strength of, our proprietary index products, reflecting industry-leading organic growth
- Strong growth in a diverse set of revenue streams
- Disciplined expense management
- Leveraging the scale of our business, producing higher profit margins
- An integration plan on track, with a higher run-rate expense synergy target expected to be achieved a year earlier, and
- Ongoing focus on capital allocation by reducing debt while continuing to return capital to shareholders though quarterly dividends and share repurchases

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 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; 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, 2017 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.