Cboe Global Markets, Inc.

Second Quarter 2018 Earnings Call - Prepared Remarks

Friday, August 3, 2018

Debbie Koopman, Vice President, Investor Relations

Good morning and thank you for joining us for our second 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 second-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 migration of the Cboe Options Exchange is 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.

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

Ed Tilly, Vice Chairman and CEO

Good morning and thank you for joining us today.

Before jumping into our quarterly report, I'll touch on yesterday's announcement of our plans to transfer the primary listing of our company's stock on our own exchange on September 17, 2018 under our existing ticker symbol, "CBOE." The move leverages the strengths of Cboe Global Markets and, as a leading equities market operator, it is a point of pride internally to exclusively list our stock on our own venue.

I am pleased now to report on a strong second quarter 2018 at Cboe Global Markets, where we increased our adjusted earnings per share by 21 percent year-over-year to $1.05, with net revenue of $284 million, which was up 6 percent. Additionally, as we announced earlier this week, our board increased our share repurchase authorization by $100 million and raised the third quarter cash dividend by 15 percent, to $0.31 per share. This marks the eighth consecutive year that our Board has raised our dividend and the second time this year we increased our share repurchase authorization, reflecting our confidence in the future cash flow generating capabilities of our business and our ongoing focus on efficiently allocating capital to create long-term shareholder value.

Turning now to volume in the second quarter and a look at the environment going forward.

We continued to see notable success in our FX market, growing average daily notional value for the second quarter by 38 percent from the prior year. In addition, we saw healthy growth in our European Equities, driven primarily by stronger revenue capture. The major growth story for the quarter, of course, was the ongoing double-digit growth in SPX options.

Trading in SPX options, the most widely-traded index options complex in the world, increased 18 percent for the quarter. Together VIX and SPX form a powerful set of risk management tools for investors globally. As we've said in the past, traders are becoming increasingly attuned to the unique properties of our products and use them opportunistically to hedge, generate alpha or simply take a position on the direction and volatility of the U.S. stock market.

Clearly, market conditions in the second quarter favored SPX options as a more cost effective way to hedge market exposure and to monetize market moves than VIX options on a relative basis. The choppy trading we saw in the weeks following February 5 continued into the second quarter. Daily close-to-close and intraday moves in the S&P 500 were, on average, two times greater than before February, and created opportunities for SPX option traders looking to monetize those price swings.

At the same time, our VVIX Index – which reflects the cost of VIX options – continued to trade at historically elevated levels.

While market conditions were favorable for SPX trading in the second quarter, the lingering instability in the VIX futures term structure made it difficult for traders to consistently harvest the roll-down premium, measured by the difference between first- and second-month VIX futures prices. This premium is important because it generates returns for short volatility strategies using VIX futures and volatility-related ETPs. As the VIX futures curve moved back and forth between upward-sloping and flat, the average roll-down premium was only about a third of what it was in 2017. Recently, though, we have seen a return to the stable, upward-sloping pattern that is more conducive to short volatility strategies. In July, the VIX futures curve was in contango every day, and the average roll-down premium recovered to just under 2017 levels.

With stock prices largely recovering from their February lows, and the ever-present threat of a global trade war, we are seeing growing demand for market hedges. Not only has SPX options volume remained solid, but in May and June, we began to see more large trades in VIX options, as the VIX Index trended below 15 for the first time since February and averaging just over 13 in July.

We've said many times before that we <u>expect</u> market conditions to change, and we <u>expect</u> a shift in how traders use our products when markets move and opportunities change. We are confident that our SPX and VIX products offer a complementary set of trading tools to manage risk in any market environment.

I'll note here that, in the face of recent liquidity challenges in other global markets, we are particularly encouraged by growth in the displayed size in our proprietary SPX and VIX options, which in each of the past two months has exceeded every month in 2017. Since moving SPX options to our hybrid trading platform at the end of April, displayed size has increased significantly, and currently averages over 500 contracts.

With consistent volume growth, and now displayed size of $150 million notional value on average, our SPX option complex offers a robust set of trading tools for traders around the world, and continues to be the go-to market for hedging U.S. equities.

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

As traders regroup on the volatility front and as we come out of a typically quieter summer trading season, we are gearing up to expand our Risk Management Conference (RMC) program this fall with the addition of a mini-RMC to be held in Tel Aviv in November. Our Tel Aviv event will follow this year's annual RMC Europe in Ireland and will precede our annual RMC Asia in Hong Kong. We have seen strong trading and growing interest in VIX futures and options in the Israeli market and look forward to introducing RMC to the region. We will continue to use the one-day mini-RMC format based on customer demand and where we see strong potential to increase trading in our proprietary products around the globe.

We leveraged our product innovation expertise to tap into the growing corporate bond marketplace with the creation of Cboe iBoxx futures, which we plan to launch later this quarter, subject to regulatory review.

Cboe iBoxx futures are expected to allow market participants globally to efficiently participate in the $8.5 trillion U.S. corporate bond market and to hedge the corporate bond credit risk of ETFs or U.S. Treasury bonds with a standardized, centrally-cleared trading vehicle. We have received very positive customer feedback on this product, which will be the first exchange-listed futures product linked to a broad-based corporate bond index.

We are pleased to be working with BlackRock and Markit to take iBoxx futures from product concept to tradable reality. IBHY futures represent a significant first step for Cboe into the credit space, and we intend to further expand our presence in that space through ongoing collaboration with Markit.

We are also working diligently to prepare our business for a post-Brexit world. On July 3rd, we announced plans to establish a new venue in Amsterdam, which leaves us well positioned to continue to serve customers across Europe after the UK's planned exit from the European Union.

We believe the Netherlands is supportive of competitive and open financial market infrastructures, and Amsterdam is a well-known location for us given our ownership stake in pan-European clearinghouse EuroCCP, which is also based there. Additionally, we have longstanding, good relations with the Dutch Authority for the Financial Markets (AFM) and central bank, which we believe share a deep understanding of the equities and derivatives markets.

We will continue to operate our existing Recognised Investment Exchange in the UK, and our intention is to offer similar services in both the UK and EU venues. Mark Hemsley and team are working closely with our European customers, who are also busy executing Brexit plans, to ensure preparedness.

Turning now to the migration of Cboe exchanges onto Bats proprietary technology. We successfully completed our on-time migration of C2 Options Exchange on May 14th and are now fully engaged in our migration of Cboe Options Exchange, targeted for October 7, 2019.

The completion of the CFE and C2 migrations, and the introduction of several technical enhancements in preparation for the Cboe migration, leave us well on track to our ultimate goal of providing our customers with a common, world-class trading experience across all our equities, options and futures markets.

In closing, I would like thank our team for another strong quarter. We continued to lay the groundwork for future growth with our planned roll out of Cboe iBoxx futures, by expanding our global educational efforts and by advancing our technology integration. I look forward to all that we can accomplish to power the potential of our customers and shareholders in the coming months and quarters.

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

Brian Schell, Executive Vice President and CFO

Thanks Ed. And good morning, everyone.

Before I begin, I want to remind everyone that unless specifically noted, my comments relate to 2Q18 as compared to 2Q17 and are based on our non-GAAP adjusted results. As Ed already noted, we reported solid financial results for the quarter. In summary:

- Our net revenue grew 6%, with:
    - net transaction fees up 5%;
    - non-transaction revenue up 8%;
- Adjusted operating expenses increased 5%
- Adjusted EBITDA of $188 million grew 5%,
- And finally, our adjusted diluted earnings per share also grew 21% to $1.05.

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 briefly highlight some of the key drivers influencing our performance in each segment.

In our options segment, the 8% increase in net revenue was primarily driven by higher net transaction fees from our index options, which resulted from a 9% increase in revenue per contract (RPC), offset slightly by a 1% decrease in average daily volume (ADV). The increased RPC primarily reflects a shift in the mix of index products traded – with more coming from SPX options, as well as pricing changes implemented at the beginning of the year. While market share was down in our multiply-listed options business, this was more than offset primarily by higher RPC, as we attracted more profitable flow to our options market; as well as, higher industry volumes.

Turning to futures, the 13% decrease in net revenue resulted from a 16% decrease in ADV and a 7% decline in RPC – with the latter reflecting a shift in the volume mix towards participants qualifying for lower trading fees. To enhance revenue capture, we recently modified the fee schedule for VIX futures, with changes effective August 1st.

Turning to U.S. Equities, net revenue grew 4%, primarily driven by higher market data revenues, which was up 8% in the second quarter, with SIP market data revenue up 4% and proprietary market data up 22%. The increase in SIP revenue was primarily due to audit recoveries. Looking at the growth in our proprietary market data revenue, the majority came from pricing changes implemented at the beginning of the year, however, about 20% of the increase this quarter came from subscription growth. We expect continued growth in proprietary market data in 2018 as we benefit from pricing changes and customer response to our Cboe One product and, absent any additional audit recoveries, which are unpredictable, as well as any pricing changes, we expect downward pressure on SIP market data revenue due to industry consolidation.

Net revenue for European Equities increased 26% on a U.S. dollar basis, reflecting growth in both net transaction and non-transaction revenues, as well as strength of the pound sterling versus the U.S. dollar. On a local currency basis, net revenue increased a healthy 12%. Higher net transaction fees were the key growth driver, reflecting favorable net capture, despite a 2% decline in market volumes.

The higher capture resulted from strong periodic auction volume, which has a higher relative net capture, as well as, price changes implemented January 1. And given the better than expected response to our periodic auctions and assuming no significant mix shift, we expect the capture rate for the second half of the year to be in line with the strong rate we reported for the second quarter. The increase in market data fees and access fees was primarily due to price changes implemented on January 1.

Net revenue for Global FX grew 33% this quarter, with revenue nearly matching our record first quarter. While second quarter volumes declined modestly versus the first quarter, it grew 38% year-over-year and our market share remained strong at 14.9%.

While growth in the overall spot FX market has been favorable, we continue to believe our market share is the result of our ongoing technology enhancements as well as more effective liquidity provisioning.

Turning to expenses, total adjusted operating expenses were $106 million for the quarter, up 5% compared with last year's second quarter. The key expense variance was in compensation and benefits, resulting from (1) higher salaries, primarily a result of annual salary adjustments and lower capitalization of wages relating to software development; and (2) higher incentive compensation, which is aligned with our year-to-date financial performance and differences in the timing of expense recognition versus last year as we harmonized bonus programs under the combined company.

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. In total, these items accounted for about $3.5 million in incremental expenses this quarter, with the currency impact being the largest. If you also adjust for those items, expenses would be up about one percent.

We are reconfirming our full-year expense guidance to be in the range of $420 to $428 million.

For the second quarter we realized $4.2 million in pre-tax expense synergies, primarily from compensation and benefits, bringing year-to-date expense synergies to $7.2 million.

Turning to income taxes, our effective tax rate on adjusted earnings for the quarter was approximately 29%, above the high end of our annual guidance range of 26.5% to 28.5%, but in line with the guidance we provided on our last earnings call. The effective tax rate on adjusted earnings in the second quarter of 2017 was 36.2%. 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 third and fourth quarters expected to be at the higher end, but within our guidance range.

In addition, we are lowering our guidance for cap-ex and for depreciation and amortization. We now expect cap-ex to be $35 to $40 million versus our previous guidance of $45 to $50 million. This change reflects more efficient technology spending and lower software development capitalization. We are also lowering our guidance for depreciation and amortization to $43 to $48 million, versus our previous guidance of $53 to $58 million, reflecting, in part, the lower cap-ex.

Moving to capital allocation, our strong financial results, cash flow generation and financial position enabled us to reprioritize our capital deployment this quarter in favor of share repurchases, while also investing in the growth of business and making dividend payments. We returned nearly $79 million to our shareholders this quarter through more than $48 million of share repurchases of our common stock and $31 million of dividends. In addition, as Ed mentioned, our Board increased our share repurchase authorization by $100 million and raised our third quarter cash dividend by 15% to $0.31 per share, underscoring our unwavering commitment to enhancing value for our shareholders – in part by returning capital directly to them.

Year-to-date through July 31st, we have repurchased approximately 1.1 million shares of Cboe common stock for nearly $122 million.

We ended the quarter with adjusted cash and investments of $116 million and our leverage ratio was unchanged from last quarter at 1.6 times.

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

- Our focus on growing our proprietary index products, as we prepare to expand into a new asset class by launching the first broad-based U.S. corporate bond index futures
- Growth in a diverse set of revenue streams
- Disciplined expense management
- Leveraging the scale of our business, producing higher operating profit margins
- An integration plan on track, and
- Ongoing focus on capital allocation by continuing to return capital to shareholders though quarterly dividends and share repurchases, while raising the quarterly dividend

With that I will turn it over to Debbie, for instructions on the Q&A portion of the call.

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.

Closing:

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

Cautionary Statements Regarding Forward-Looking Information:

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

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

Some factors that could cause actual results to differ include: the loss of our right to exclusively list and trade certain index options and futures products; economic, political and market conditions; compliance with legal and regulatory obligations; 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.