Cboe Global Markets, Inc.
Third Quarter 2018 Earnings Call - Prepared Remarks
Friday, November 2, 2018

Debbie Koopman, Vice President, 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, Brian Schell, our Executive Vice President and CFO, will provide an overview of our third-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, Chairman and CEO

Good morning and thank you for joining us today.

I am pleased to report on a strong third quarter 2018 at Cboe Global Markets, where we increased our adjusted earnings per share by 19 percent year-over-year to $1.06, with net revenue of $271 million. Our solid financial results enabled us to continue to invest in our long-term growth while returning nearly $84 million of capital to our shareholders through dividends and share repurchases.

Trading in SPX options continued to grow at a double-digit pace, increasing 12 percent for the quarter over Q3 2017. We saw trading volume in VIX options and futures slowly build month-over-month throughout the quarter, then surge in October as volatility increased and investors around the world turned to Cboe to manage their risk.

Other volume highlights for the quarter included ongoing success in our FX market, where average daily notional value for the third quarter grew 19 percent from the prior year. We also saw continued growth in our European equities business, with increases in market share and volume.

A look now at the volatility landscape throughout the quarter and beyond. As major stock market averages hit all-time highs and we are now in the longest running bull market in history, we saw the VIX futures term structure return to its normal upward-sloping shape along with steady volume increases in our VIX product complex.

As we expected, the lingering effect of the February market shock that led to a flat VIX futures term structure in the second quarter was unsustainable, and we began to see growth in trading strategies used to capture volatility risk premium, volatility hedges and a return of large trades in VIX options.

The return of higher volatility in October that led to record volumes in SPX options and VIX futures was fueled by an 11% decline in the S&P 500, comparable to the move we saw in February. Yet, the VIX Index and VIX futures suggest that the current volatility environment is substantially different than what we experienced earlier this year. We expect to see changes in the VIX Index when markets move and risk expectations change. We believe the difference this time is that the correction was not compressed over just a few days as it was in February. Rather, we saw an orderly re-pricing of risk that has occurred over a period of weeks, allowing traders to monetize hedges in both SPX and VIX options and reposition their exposures tactically.

Regardless of market conditions, we remain focused on our commitments to product innovation, seamless trading solutions and leading-edge technology.

Product innovation remains the cornerstone of our growth strategy. I'm pleased to report on our entry into the growing corporate bond marketplace with the successful launch of futures on the Cboe® iBoxx® iShares® High Yield Corporate Bond Index (IBHY) on September 10th and Investment Grade Corporate Bond Index (IBIG) on October 8th.

Cboe corporate bond index futures were designed in collaboration with Markit and BlackRock to enable market participants worldwide to hedge positions and gain exposure to key segments of the roughly $8.8 trillion corporate bond market.

We were encouraged by the strong market quality we saw right out of the gate, which we see as testament to the design and utility of the products and to our close collaboration with our liquidity providing community. Volume and open interest continued to build in line with our expectations for these early days of trading.

We are enthusiastic about our prospects to steadily increase use of these products and we look forward to further expanding our presence in this space with additional products going forward.

Turning now to Cboe Europe, where we are ten months into MiFID II and the solutions we put in place for this new regulatory regime continue to see strong adoption. Our Periodic Auctions book has established itself as a leading non-continuous platform, while our relationship with BIDS Trading continues to blossom. Our block-trading platform, Cboe LIS, powered by BIDS technology, logged another record quarter with €250 million in daily volume.

We continue to diligently prepare for a post-Brexit world. We are in the process of establishing an EU venue in Amsterdam, which will allow us to effectively serve our customers in the absence of an agreed 'exit deal' between the UK and the EU.

We are currently working with the Dutch regulators and preparing to on-board customers to our new venue. We are also monitoring Brexit negotiations and will be prepared to respond as quickly as possible to any developments that would cause us to alter our strategy.

Turning now to the final migration of Cboe exchanges onto Bats proprietary technology. We are now fully engaged in the multi-phased migration of Cboe Options Exchange and are on track to reach our migration target date of October 7, 2019. We are pleased that we are now less than one year away from our ultimate goal of providing our customers with a single, world-class trading experience across all our equities, options and futures markets.

Given the recent attention on equity market data fees, I will take a moment to provide our views on that important matter before closing. First, I would like to reiterate that Cboe's growth strategy as it relates to market data revenue has been and remains focused on expanding our user base. We are confident in the value proposition offered by our suite of competitively-priced market data products across asset classes. These offerings are tailored to meet the needs of our customers and we will continue to innovate in this arena to meet customer demand.

With regard to the recent SEC opinion, which did not involve Cboe directly, and the SEC order, which implicates some Cboe filings: we believe the SEC exceeded its authority in issuing the order and last week filed a motion requesting the SEC vacate its order.

We stand by our products and our fees and are hopeful the SEC roundtables clarified some of the misunderstanding concerning exchange market data fees and that our motion requesting the SEC to vacate the Order will prevail. While litigation could likely take years to resolve, we will remain focused on building upon the product development and growth initiatives that drove our strong third quarter and our continued strong volume through October.

In closing, I would like thank our team for continuing to lay the groundwork for future growth with the successful roll out of Cboe corporate bond futures, by continuing to provide seamless trading solutions for our customers 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 months and quarters to come.

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

Thanks Ed. And good morning, everyone.

Brian Schell, CFO

Before I begin, I want to remind everyone that unless specifically noted, my comments relate to 3Q18 as compared to 3Q17 and are based on our non-GAAP adjusted results. We reported another quarter of solid financial results. In summary:

- Our net revenue was up nominally, with:
    - net transaction fees down 3%;
    - non-transaction revenue up 5%;
- Adjusted operating expenses declined 3%
- Adjusted operating income of $171 million grew 2%,
- And finally, our adjusted diluted earnings per share grew 19% to $1.06.

It's worth noting that these results were achieved despite a decline in volume in our proprietary products, reflecting our more diversified mix of revenue.

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. I'd like to briefly highlight some of the key drivers influencing our performance in each segment.

In our options segment, the 2% or $2.5 million increase in net revenue was primarily driven by an increases of $3.4 million in net transaction fees from our multiply-listed options and $2.4 million in access fees, offset somewhat by a $4.9 million decline in net transaction fees from index options. Index options average daily volume (ADV) decreased 14% for the quarter, reflecting a 47% decline in VIX options offset somewhat by a 12% increase in SPX options. However, as Ed mentioned, index options volume improved month-over-month throughout the quarter in both VIX and SPX. The impact of the decline in index options ADV was offset somewhat by a 10% increase in RPC, resulting from a shift in the mix – with SPX options accounting for a higher percentage of volume, as well as pricing changes implemented at the beginning of the year. The 6% ADV increase in our multiply-listed options business was primarily driven by higher industry volumes. Our market share was down from last year's third quarter as we continue to focus on optimizing our overall net transaction fees, reflected in an 11% increase in RPC for multiply-listed options for the quarter.

Turning to futures, the decline in net revenue resulted from a 28% decrease in ADV and a 3% decline in RPC, offset somewhat by growth in non-transaction revenue. RPC was lower year-over-year due to a shift in the volume mix, with fewer block trades, which have a higher revenue capture. However, 3Q RPC was up 4% compared to the second quarter, reflecting the impact of fee changes implemented on August 1st, as well as a more favorable overall mix. VIX futures volume picked up in the second half of the third quarter and surged in October as volatility heightened, setting a monthly volume record for October. VIX futures had ADV of 420,000 contracts in October, up 79% versus the third quarter and 58% above October of last year.

Turning to U.S. Equities, net revenue grew 2%, primarily driven by increases in net transaction fees and exchange services and other fees.

As we expected, SIP market data revenue fell 12% and our proprietary market data increased 27%. As an industry low-cost provider, we plan to continue to focus our efforts on growing our proprietary market data by attracting new users and innovating to meet client needs. We continue to expect downward pressure on SIP market data revenue, absent audit recoveries, due to industry consolidation and historical trends.

Net revenue for European Equities increased 21% on a U.S. dollar basis and up 22% on a local currency basis, reflecting growth in both net transaction and non-transaction revenues. Net transaction fees were the key growth driver, reflecting favorable net capture and higher market share on relatively flat market volumes. The higher capture resulted from strong periodic auction volume and LIS volume, which have higher relative net captures, as well as price changes implemented January 1.

Net revenue for Global FX grew 20% this quarter, as we maintained our strong market share at 14.8%, up nearly 200 basis points year-over-year. The growth reflects favorable market volumes, stronger market share and a disciplined pricing schedule.

Turning to expenses, total adjusted operating expenses were $99 million for the quarter, down 3% compared with last year's third quarter. The key expense variances were (1) lower depreciation and amortization, primarily a result of the accelerated pace recognized in 2017 and the retirement of certain assets this year; and (2) lower travel and promotional expenses, due to a targeted reduction in advertising-related expenses.

We are reconfirming our full-year expense guidance to be in the range of $420 to $428 million. While we expect to be at the lower end of that range, it will depend on fourth quarter volume levels as about 35% of our compensation and benefits expense is variable and will self-adjust based on our financial performance and other metrics.

For the third quarter we realized $5.0 million in pre-tax expense synergies, primarily from compensation and benefits, bringing year-to-date expense synergies to $12.2 million.

Turning to income taxes, our effective tax rate on adjusted earnings for the quarter was approximately 26%, slightly below the low end of our annual guidance range of 26.5% to 28.5%. The effective tax rate on adjusted earnings in the third quarter of 2017 was about 36%. 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 within our guidance range of 26.5% to 28.5% for the year, with the tax rate for the fourth quarter expected to be at the higher end of the range.

In addition, we are reaffirming our guidance for cap-ex of $35 to $40 million and for depreciation and amortization of $43 to $48 million.

Moving to capital allocation, our strong financial results, cash flow generation and financial position enabled us to continue to invest in the growth of our business while also returning capital to shareholders. We returned nearly $84 million to shareholders this quarter through about $49 million of share repurchases of our common stock and $35 million of dividends.

Year-to-date through September, we have repurchased approximately 1.3 million shares of Cboe common stock under our share repurchase program for nearly $141 million, representing 1% of shares outstanding.

We ended the quarter with adjusted cash and investments of $138 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, expanding 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 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.

We look forward to sharing our fourth quarter results and our outlook for 2019 on our fourth quarter earnings call in early February. With that I will turn it over to Debbie, for instructions on the Q&A portion of the call.

Debbie Koopman

At this point, we would be happy to take questions. We ask that you please limit your questions to one per person to allow time to get to everyone. Feel free to get back in the queue and if time permits we'll take a second question.

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

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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.

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