Cboe Global Markets, Inc.
Fourth Quarter 2018 Earnings Call - Prepared Remarks
Friday, February 8, 2019

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, President 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 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 Chief Operating Officer, Chris Isaacson 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, President and CEO

Good morning and thank you for joining us today.

I am pleased to report on record financial results for the fourth quarter and year in 2018 at Cboe Global Markets, fueled by increased trading across all of our business lines and, most notably, record trading in our proprietary products.

Our strong performance in 2018 demonstrated our ability to effectively leverage our increased global reach and expanded product line. After a brief overview on market volatility, I will touch on high-level results for each of our business lines and highlight how we plan to build on those results in 2019.

After hitting an all-time high in September, the stock market fell sharply during the fourth quarter fueled in part by investor fears of rising interest rates, escalating trade tensions and the risk of a global recession. In December, stocks briefly entered bear market territory before rallying to close out 2018. For the year, the S&P 500 Index suffered its largest annual decline since the 2008 Financial Crisis, falling by more than 6%.

Large daily moves and rapidly changing perceptions of risk marked the fourth quarter, which was the most volatile since 2011, and was the backdrop for record trading activity in our proprietary products. Realized volatility for the period was 24, while the VIX Index, which reflects the implied volatility of SPX options, averaged 21, an unusual inverted condition that made SPX options an especially attractive and cost effective hedging and trading tool.

Despite an 8 percent increase in the S&P 500 and a 35 percent decline in the VIX Index since year-end, market observers generally agree that higher volatility will become the "new normal" for stocks. They point to the same risk factors that fueled the market correction in 2018, and warn that the robust equity returns investors enjoyed over the past 10 years are unlikely to continue. As such, we expect that demand for equity hedges using SPX options, and VIX options and futures, will increase in 2019.

As we've frequently noted, our suite of proprietary index products provide unique and complementary tools to help investors manage risk in most any market environment, and many customers use VIX options and futures and SPX options in tandem, depending on market conditions.

Given increased volatility, year-over-year trading in VIX futures rose 18 percent in the fourth quarter, fueling the 14th consecutive record volume year in VIX futures. Fourth quarter VIX options volume, while down from the previous year, increased over the previous quarter, and SPX options reached a record volume high for the 6th consecutive year and set a new record in global trading hours.

Whether branching out into new markets, such as the Middle East, Scandinavia, and Asia, or further penetrating existing markets, the demand for education around our proprietary products has never been greater. In response, we've revamped our Sales and Marketing teams to better respond to key market segments and geographies with an emphasis on education.

Specific user groups we've targeted include commodity trading advisors, where we've seen growing use of VIX futures, but not widespread adoption. Similarly, we continue to identify asset managers and hedge funds with diversified portfolios of investments, yet no allocation to volatility. We are working closely with these communities to demonstrate the powerful impact that a small allocation to volatility can have on a broad portfolio.

We saw increased demand in VIX options from the buy-side in 2018 and intend to build on that trend with a focused sales campaign in 2019. Efforts are also underway to partner with sell-side banks to provide further incentives to increase VIX trading.

We also plan to run a directed sales campaign focused on new and existing institutions in the hedge fund community, which actively participates in the VIX complex, but where we see considerable room for growth.

In 2019, we remain committed to what has been a very successful play book in growing the use of SPX options globally: educating new users, both retail and institutional, on the utility of SPX in virtually any market climate. We will continue to actively educate and market to our retail client segment, including through partnerships with key retail firms, and to our institutional base, where we still see considerable opportunity among large pensions and global asset managers.

And, while we continue to see increased trading during global trading hours, we believe there is significant untapped potential for growth in non-U.S. regions and are increasing our overseas educational efforts accordingly.

Turning now to our overall options business. Options average daily volume increased 23 percent for the quarter and 14 percent for the year at Cboe Global Markets, the number one U.S. options marketplace. Multi-list options increased 22 percent in the fourth quarter and 14 percent for the year, while index options trading rose 24 percent in the fourth quarter, making 2018 the sixth consecutive record year in that category. In addition to growing our options market through the aforementioned VIX and SPX options initiatives in 2019, we look to increase trading in XSP -- our “mini” SPX options -- which trade on Cboe, by also adding them to our EDGX exchange, subject to regulatory review.

We also plan to continue to grow our index marketplace through product innovation. We are pleased to expand our suite of products tied to S&P Dow Jones Indices with the rollout of options on 11 Select Sector Indices. We launched options on the Material Select Sector Index yesterday and plan to launch options on the 10 remaining indices next week. We expect the new options to have particular utility for investors seeking an alternative to options on exchange-traded funds (ETFs), including European customers seeking an alternative due to certain European regulations.

Turning now to the positive results in our equities marketplace. Growth in U.S. equities was fueled by a 33 percent increase in industry ADV for the quarter and 12 percent over the previous year. Our ETP business also grew in the fourth quarter, bringing our total number of ETP listings to 290 at year’s end, an increase of 16 percent over 2017’s total. Our ETP offering now includes VXXB, the largest volatility-linked ETP, which replaces VXX.

We are excited about the potential for ongoing data sales growth in 2019 as we continue to distribute our products, including our flagship Cboe One feed, around the globe. Cboe’s growth strategy as it relates to market data revenue remains focused on expanding users and providing products that meet client needs, while leveraging our position as an industry low-cost provider. And, while we believe that the SEC exceeded its authority in issuing its recent market data order, and we filed a motion to reconsider the order, I should reiterate that the order has no impact on our existing market data fees and that our fee schedules remain unchanged. We are confident in the value proposition offered by our suite of market data offerings, which are tailored to meet the needs of our customers, and we remain fully committed to offering these products.

With regard to new competitors in the U.S. equities space, it should be noted that we’ve always been priced at a relative discount to our competitors for data and capacity fees and that today’s equities landscape is much different than it was in 2007, when Bats entered the marketplace and trading fees subsequently compressed materially. Rules relating to order routing and best execution have also changed and associated costs are down considerably. We don’t see much room for lower prices on any front. Further, we believe our operational efficiencies, cross-asset product mix and four exchange medallions enable us to bring unique value to our customers and leave us well-positioned in this hyper-competitive market.

We also believe the unique benefits of our equities business model and our ability to be nimble will leave us well positioned with regard to the U.S. equities transaction fee pilot. Evolving our business model to meet industry and customer needs is in our DNA. We remain fiercely opposed to the pilot and will fight against it at every possible turn, but we are confident we will continue to compete aggressively should the pilot be enacted.

Turning now to European equities trading (ADNV), which increased 19 percent for the quarter and 11 percent over 2017, and Cboe LIS, our European block-trading platform powered by BIDS technology, logged another record quarter. Our strong results were a result of the rapid adoption of the services we put in place to meet the market needs under MiFID II. We are now positioning our business to continue to grow in a post-Brexit environment and are in the final stages of preparing to launch our new EU venue in Amsterdam, subject to regulatory review.

Global FX average daily notional value was up 8 percent for the fourth quarter and 27% for the year, leading to another record year in 2018. We plan to build on that success by improving our customers' experience through advanced data and analytics combined with industry leading liquidity.

In closing, I would like thank our team for a great fourth quarter and for making 2018 a year for the record books. It is a credit to the entire team that we were able to deliver strong results across a greatly expanded product line. We plan to build on those results in 2019, not only with the initiatives outlined here, but with the planned completion of the migration of Cboe exchanges to Bats technology on October 7th, when all of Cboe's options, futures and equities markets will trade on a single world-class platform. Moreover, we will continue to redefine markets through our commitment to relentless product innovation, leading-edge technology, and seamless trading solutions in ways that benefit our customers and shareholders alike.

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

Good morning and thank you for joining us today.

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 4Q18 as compared to 4Q17 and are based on our non-GAAP adjusted results. As Ed mentioned, Cboe had a record quarter.

- Our net revenue was up 26%, with:
    - net transaction fees up 37%;
    - non-transaction revenue up 8%;
- Adjusted operating expenses increased 6%
- Adjusted operating margin of 66.6%, up 610 basis points,
- And finally, our adjusted diluted earnings per share grew 77% to $1.54.

Our record results were driven by revenue growth across each of our business segments. This growth combined with our focus on disciplined expense management, allowed us to achieve the operating leverage reflected in our margin expansion, which is inherent in our operating model.

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 34% or nearly $45 million increase in net revenue was primarily driven by an increase of $46 million in net transaction fees, reflecting growth in trading volume and revenue per contract in both index options and multiply-listed options – with index options up $32 million and multiply-listed options up $14 million. The growth in net transaction fees for index options resulted from an increase in average daily volume (ADV) of 24% for the quarter, reflecting a 38% increase in SPX options offset somewhat by a 2% decrease in VIX options and 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 22% ADV increase in our multiply-listed options business was primarily driven by higher industry volumes. Industry options volume reached a new high in 2018, surpassing the previous record set in 2011. Our market share was down from last year's fourth quarter as we continued to focus on optimizing our overall net transaction fees in 2018, which is reflected in a 48% increase in RPC for multiply-listed options for the quarter and 17% for the year.

Turning to futures, the 13% increase in net revenue primarily resulted from a 19% increase in ADV offset somewhat by a 6% decline in RPC. RPC was lower year-over-year primarily due to a shift in the volume mix, with fewer block trades, which have a higher revenue capture.

CFE also posted growth in non-transaction fees for the quarter and the year, driven by demand for market data and connectivity or capacity fees, which were modified in May 2018 following CFE's technology migration in February 2018.

Turning to U.S. Equities, net revenue grew 18%, primarily driven by increases in net transaction fees and exchange services and other fees. Net transaction fees were driven by higher net capture and industry ADV, offset somewhat by lower market share.

SIP market data revenue fell 4% in the quarter and our proprietary market data increased 28%. We expect SIP market data revenue to be relatively unchanged year-over-year in 2019, absent audit recoveries and assuming no significant changes in market share.

Net revenue for European Equities increased 29% on a U.S. dollar basis and was up 31% 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 stronger market volumes. The higher capture resulted from strong periodic auction and LIS volume, which have higher relative net captures.

Net revenue for Global FX increased 14% this quarter, as we grew market share to 15.3%, up nearly 40 basis points year-over-year. The growth reflects favorable market volumes and stronger net capture.

Turning to expenses, total adjusted operating expenses were nearly $112 million for the quarter, up 6% compared with last year's fourth quarter. The key expense variance was in compensation and benefits, resulting from higher incentive-based compensation – driven by, and aligned with, our strong financial and operational performance.

We exited 2018 with a cumulative run-rate expense synergy of $57 million versus our previous estimate of $50 million and we still expect to exit 2019 with $80 million of run-rate synergies and $85 million in 2020. Additionally, we want to provide you with incremental visibility to our expectation of how much expense synergy we expect to actually realize this year and in 2020.

Given that the C1 migration is planned to occur in the fourth quarter, we expect to realize approximately 20% of the incremental $23 million of targeted run rate synergies during 2019, which is a significantly lower percentage than the previous two years. In 2017 and 2018, higher percentages of synergies were realized – 75% and 64%, respectively - as many personnel and vendor decisions were made shortly after closing in 2017. And in 2018 we completed the CFE and C2 platform migrations earlier in the year. We also estimate that we plan to realize approximately 40% of the remaining $5 million of run rate synergies in 2020.

Expense Guidance

With the synergy discussion as context, we'd now like to review our expense guidance for the full-year 2019 and a preliminary range for 2020. For 2019, we expect adjusted operating expenses to be in a range of $420 to $428 million, reflecting our expectation for expenses to be slightly down to nominally flat versus 2018. Our 2019 projected expenses reflect the benefit of synergies attained through 2018 and growth of core expenses to support our business.

With respect to 2020, we expect a similar range of $420 to $428 million reflecting the significant carryover benefit realized in 2020 for the C1 migration in 2019, which is likely to offset a 4-6% core expense growth rate in 2020.

Depreciation and amortization

Depreciation and amortization expense, which is included in our total adjusted expense guidance, is expected to be $35 to $40 million. This excludes the amortization of acquired intangible assets of about $138 million, which will be excluded from our non-GAAP results.

Capital Spending

Lastly, capex in 2019 is expected to range from $50 to $55 million, an increase from $37 million in 2018. A significant driver of the increase in our forecast is an assumption that we will spend additional capital for the possible relocation and leasing of our Chicago corporate office headquarters, accounting for about a third of the incremental spend. We have no definitive plans to share at this point, but if we do decide to relocate, we would not expect to incur the increased capital expenditures until the second half of 2019, at which time we would likely be able to provide more clarity. The capital budget also includes our ongoing investment in technology and software to refresh, enhance and add capacity to our systems, including potential Brexit-related spending.

2018 Tax Rate and Guidance

Turning to income taxes, our effective tax rate on adjusted earnings for the quarter was about 22%, below our annual guidance range of 26.5% to 28.5%, reflecting several positive discrete items relating to state income taxes. The effective tax rate on adjusted earnings in the fourth quarter of 2017 was 37%. The decline primarily reflects the favorable impact of corporate tax reform.

We expect the annual effective tax rate on adjusted earnings for 2019 to be within a range of 27 to 29% for the year, which is higher than 2018 due to the expectation of realizing fewer favorable discrete tax items in 2019.

Turning to capital allocation, we remain focused on allocating capital in the most efficient manner to create long-term shareholder value.

During the fourth quarter, 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 nearly $35 million to shareholders through dividends. We ended the year with adjusted cash of nearly $258 million.

We were not active in share repurchases during the fourth quarter of 2018. Instead, we conserved cash to utilize towards a potential near-term strategic acquisition. While we are unable to provide any specifics relating to this potential deal, and there is no assurance it will ultimately occur, I want to point out that if we are successful in completing the transaction, we do not anticipate incurring significant leverage or issuing any stock with respect to its funding.

Turning to share repurchases, for the full year 2018 we 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 currently have $206 million of availability under our share repurchase program and we plan to continue to *evaluate* share repurchases as part of our capital allocation.

At year end our leverage ratio was 1.5 times, down slightly from 1.6 times at the end of 3Q18.

In summary, Cboe delivered record results for both the quarter and the year and continued to demonstrate:

- Our focus on growing our proprietary index products
- 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 invest in the growth of our business while returning 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.

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.

Cautionary Statements Regarding Forward-Looking Information and Trademarks:

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.