Cboe Global Markets, Inc.
First Quarter 2018 Earnings Call - Prepared Remarks
May 3, 2019

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Good morning and thank you for joining us for our first 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 first quarter 2019 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 financial results for the first quarter 2019 at Cboe Global Markets. As you know market conditions were challenging throughout the quarter, negatively impacting volume across our business lines. As we have in previous low volume cycles, we have used this less volatile period to seed potential future growth in our proprietary index products through increased customer outreach and education efforts. As a result, we are confident we are even better positioned to grow our business and to define markets globally to deliver value to our customers and shareholders. I will highlight those initiatives today, after touching on market volatility.

In a reversal from the sharp downturn in fourth quarter 2018, the S&P 500 rallied more than 12% in the first quarter and is now up more than 16% year-to-date. We believe the rally was led by the Federal Reserve's shift away from monetary tightening, generally positive corporate earnings, and growing stability in U.S.-China trade talks.

As the markets are once again hitting all-time highs, implied volatility levels have fallen across all asset classes and the VIX term structure has steepened. We see that investors are looking for ways to re-establish upside positions and, with realized volatility levels back near 8 month lows, industry strategists are pointing to trades in SPX and VIX as ways to take a position in the market.

Others are turning to VIX futures and Volatility-linked ETPs to express a view on implied volatility. Volatility-linked ETP AUM, which bottomed out at the start of 2019, has been steadily building and is now back over $3.5 billion, quickly approaching pre-February 5th 2018 levels.

In the last 3 months the ETP complex has gained approximately 130 million dollars of long vega exposure. This has translated to hedging in VIX futures and according to the most recent CFTC data, has resulted in the largest net short position in VIX futures on record. Yet another example of the utility the VIX complex has to offer.

Whether record market highs or market sell offs, spikes in volatility or extended periods of market calm, the street continues to reference our proprietary product set as the preferred tools for managing risk.

We remain keenly focused on the significant opportunity we see to further grow the customer base for our proprietary products.

In the interest of better serving our customers, we have aligned our sales and coverage teams across regions and products to promote greater collaboration and cross selling. Additionally, we developed a buy-side sales team focused on growing usage of our proprietary products in the insurance, asset manager, and pension fund communities.

While we believe our greatest opportunity for growth remains in the domestic market, we also recognize that investors around the globe have US exposure. We continue to make inroads into new markets and to enhance the customer experience in regions where we already have a greater foothold. We are exploring new markets, such as the Middle East, Scandinavia, and Asia, while also pursuing jurisdictional approval in more established markets including Switzerland and Israel.

Turning now to the U.S. equities market, where this week we made fee changes aimed at attracting additional order flow to the Cboe EDGX exchange. We believe these changes, in addition to our plans to introduce execution priority to retail limit orders on EDGX, pending regulatory approval, will benefit individual investors while further enhancing EDGX as a destination of choice for retail trading.

We continue to advocate for adoption of our Cboe Market Close (CMC) proposal, which was initially approved by the SEC in January 2018, but has been stalled by appeals. We are optimistic that the original approval order will be reaffirmed by the Commissioners, and are positioned to launch upon approval. You'll recall that Cboe worked closely with customers to develop CMC to provide them with significant cost benefits.

Our commitment to being a leading advocate in the equities marketplace has never been stronger. We are crafting numerous other proposals and rule filings based on feedback from our customers. You'll hear more about these initiatives as they develop.

Now turning to European equities, where our market share remains strong one year into MiFID II. We continue to retain our #1 position in the European equities market as we increased our market share year-over-year to 22.1% for the quarter, up from 21.2%.

Our Periodic Auctions book continues to receive positive feedback from both buy-side and sell-side firms and remains the leading periodic auctions solution. Cboe LIS, our block-trading platform powered by BIDS technology, logged another strong quarter.

Our primary focus during the first quarter was finalizing our plans to operate in a post-Brexit environment. In March, we received authorization from the Dutch Ministry of Finance to operate a new venue in the Netherlands. Given the recent political developments and the extension of the Brexit deadline until the end of October 2019, we now plan to launch the new venue later this year. We continue to work with our regulators and customers on launch timing.

In closing, I would like to thank our team for the progress made throughout the first quarter in laying the foundation for future growth. In addition to the initiatives outlined here, our team continues to hit key milestones on our migration of Cboe exchanges to Bats technology, keeping us on track for our planned completion date of October 7th. We've seen ebbs in trading before. They come with the territory, but our experienced and disciplined team continues to execute on strategic growth initiatives so that our company is well positioned to weather difficult trading conditions and to benefit when they change.

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 1Q19 as compared to 1Q18 and are based on our non-GAAP adjusted results. As Ed mentioned, we had difficult comparisons given the strength of the first quarter last year versus weaker trading volumes this year. Overall -

- Our net revenue was down 15%, with:
    - net transaction fees down 24%;
    - non-transaction revenue up 2%;
- Adjusted operating expenses decreased 14%
- Adjusted operating margin of 66.5% was unchanged,
- And finally, our adjusted diluted earnings per share declined 20% to $1.11.

Our first quarter results reflect lower trading volume industrywide and across each of our business segments. In addition, our results included an $8.8 million charge, the equivalent of a $0.06 EPS impact, to reverse the OCC dividend we recognized in the fourth quarter of 2018, due to the SEC's rejection of the OCC capital plan. I'll discuss this in more detail later.

Despite the tough environment and comparisons, our focus on disciplined expense management allowed us to achieve solid margins, matching 1Q18's adjusted operating margin.

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. Before I get started let me point out a change we made in our income statement reporting. We combined access fees and exchange services and other fees into one line item - Access and Capacity Fees. We believe this enhances comparability and better captures the overall revenue associated with accessing and obtaining the desired level of capacity to trade in our markets.

Despite the lower trading volume in the first quarter, our recurring revenue stream of proprietary market data and access and capacity fees combined increased 10% YoY, which is slightly higher than we originally projected and believe we can grow this at mid-to-high-single digits in 2019. We continue to see opportunity across all of our asset classes and believe that our migration to Bats technology will provide additional revenue opportunity over the long term. As it relates to proprietary market data, about 70% of the growth was the result of incremental subscriptions.

Now I'd like to turn to our segments.

In our options segment, the 17% or nearly $29 million decrease in net revenue was primarily driven by a $40 million decline in net transaction fees, reflecting lower trading volume and revenue per contract. Net transaction fees in index options fell $39 million and multiply-listed options were down just $1 million. Index options average daily volume (ADV) declined 34% for the quarter, offset slightly by a 3% increase in RPC. The RPC increase was primarily due to a mix shift – with SPX options accounting for a higher percentage of volume, as well as fee changes implemented in first quarter of 2019. The 17% ADV decrease in our multi-listed options was primarily driven by lower industry volumes and lower market share. Our multi-list market share was down from last year's first quarter as we continued to focus on optimizing our overall net transaction fees, as reflected in a 13% increase in RPC for multi-listed options for the quarter. The RPC increase was driven by fee changes implemented in 2018 as well as lower volume-based discounts.

Turning to futures, the 30% or nearly $13 million decrease in net revenue primarily resulted from a 37% decline in ADV and a 1% increase in RPC. The higher RPC year-over-year primarily reflects the impact of new pricing implemented in the later part of 2018 and lower volume-based rebates.

CFE posted growth in non-transaction revenue of 16%, driven by higher market data revenue and regulatory fines; if you exclude the increase in regulatory fines, which may not recur, the increase is 6%.

Turning to U.S. Equities, net revenue was down 5% or nearly $4 million, primarily due to lower SIP market data revenue, offset somewhat by increases in net transaction fees and access and capacity fees. The growth in net transaction fees was driven by higher net capture, offset somewhat by lower industry ADV and market share.

SIP market data revenue fell 20% in the quarter while our proprietary market data revenue increased 2%. SIP revenue fell due to lower market share, as well as a decline in audit recoveries versus last year's first quarter. We still expect the SIP revenue pool to remain relatively unchanged in 2019 versus 2018 and expect our SIP revenue to be primarily influenced by changes in market share and any audit recoveries.

Net revenue for European Equities decreased 7% on a U.S. dollar basis, primarily reflecting the unfavorable impact of foreign-currency translation. On a local currency basis, net revenue was only down 1%. While net transaction fees were down, the decline was mostly offset by growth in non-transaction revenue. The decline in net transaction fees was due to lower market volumes, offset somewhat by favorable net capture and higher market share. The higher capture resulted from continued strong periodic auction and LIS volume, which have higher relative net captures.

Net revenue for Global FX decreased 5% this quarter, reflecting a 12 percent decline in market volumes offset significantly by higher net capture, which was up 7 percent primarily reflecting the impact of fee changes made in 2018. In addition, we grew market share to a new high of 15.8%, up nearly 50 basis points year-over-year.

Turning to expenses, total adjusted operating expenses were just over $94 million for the quarter, down 14% compared with last year's first quarter. While expenses were down some in nearly every category, the key expense variance was in compensation and benefits, primarily resulting from a decrease of nearly $7 million in incentive-based compensation and $3 million in equity compensation. The decrease in equity compensation reflects the forfeitures of unvested equity awards in the quarter and is not expected to be a recurring benefit in future quarters. The decline in incentive-based compensation is aligned with our overall decline in financial performance. As we've discussed previously, this is our largest variable expense and is self-adjusting based on financial results.

Given our first quarter expense decline, we are lowering our full-year 2019 expense guidance to be in the range of $415 to $423 million, down $5 million versus our previous guidance. In the first quarter, we had about $6 million in net favorable expense adjustments that we don't expect to recur in subsequent quarters. Additionally, as Ed discussed, we plan to continue to invest in enhancing our customer facing business development team to drive greater engagement in our proprietary products.

With respect to our 2020 expense guidance, we still expect a range of $420 to $428 million, which takes into account the benefit of the synergies expected to be realized in 2020 from the C1 migration later this year; and a continuation of investing to support the growth our business.

We are maintaining our run-rate expense synergy targets, as we expect to exit 2019 with $80 million of run-rate synergies and exit 2020 with $85 million.

Turing to income taxes, our effective tax rate on adjusted earnings for the quarter was 25.4%, below our annual guidance range and last year's first quarter rate of nearly 26%. The tax rate decrease was primarily due to excess tax benefits related to equity awards exercised in the first quarter of 2019.

We are reaffirming our full year tax rate guidance to be in a range of 27 to 29%, as we expect the rate to be at the higher end of the guidance range in each subsequent quarter for the remainder of the year.

We are also reaffirming our guidance for depreciation and amortization and capital spending, with the amounts as noted on the slide.

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

During the first quarter, our cash flow generation and financial position enabled us to continue to invest in the growth of our business while also returning nearly $70 million to shareholders through dividends and share repurchases. We currently have $171 million of availability under our share repurchase program and we plan to continue to *evaluate* share repurchases as part of our capital allocation.

We ended the quarter with adjusted cash of nearly $348 million. Our cash balance is elevated versus historical levels for a couple of reasons. First, working capital needs are typically higher at the end of the first quarter due to tax-related liabilities that are due in the second quarter. The second and most significant reason is the potential strategic acquisition we referenced in our last earnings call remains under consideration. While we are still unable to provide any specifics relating to this potential deal, and there is no assurance it will ultimately occur, I want to point out again that if we are successful in completing the transaction, we do not anticipate a significant change to our current leverage ratio or issuing any stock with respect to its funding.

At quarter end our leverage ratio was unchanged from year-end 2018, at 1.5 times.

Our cash and capital positions remain strong and we remain confident that the actions we are taking to implement our strategic initiatives will drive free cash flow and create long-term sustainable value to our shareholders.

In summary, Cboe delivered solid results amid a challenging operating environment and continued to focus on:

- Defining markets globally
- Growing our proprietary index products
- Growing our recurring revenue streams
- Disciplined expense management to leverage the scale of our business
- Completing our integration plan and delivering on our synergy targets
- Maintaining balance sheet flexibility, and
- A capital allocation plan that allows us 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.

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; potential difficulties in our migration of trading platforms and our ability to retain employees as a result of the acquisition of Bats; our ability to protect our systems and communication networks from security risks, cybersecurity risks, insider threats and unauthorized disclosure of confidential information; increasing competition by foreign and domestic entities; our dependence on and exposure to risk from third parties; fluctuations to currency exchange rates; 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; misconduct by those who use our markets or our products; 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; restrictions imposed by our debt obligations; our ability to maintain an investment grade credit rating; impairment of our goodwill, investments or intangible assets; 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, 2018 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.