Cboe Global Markets, Inc.
Second Quarter 2019 Earnings Call - Prepared Remarks
August 2, 2019

Debbie Koopman, VP, Investor Relations

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 second 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, CEO

Good morning and thank you for joining us today.

I am pleased to report on financial results for the second quarter 2019 at Cboe Global Markets, which were primarily driven by higher trading volume in proprietary products compared to the second quarter of 2018, offset by flat to lower trading volumes industrywide in U.S. equities, European equities and global FX.

We remained focused throughout the quarter on executing our strategic initiatives to drive long-term growth and value to our customers and shareholders. I will highlight those efforts after touching on the trading and market volatility landscape.

Despite an almost 6% sell off in May, the S&P 500 paired losses in June to end the quarter up a modest 4%. The June rally continued into July, touching new highs on July 26th representing a 20% gain year-to-date.

The VIX futures' near record volume in May, the 5th highest month in its 15 year history, was offset by a slow April and June as traders lacked conviction during the market's grind higher. In July, short-term consumer confidence remained cautiously optimistic, but we believe concerns over a global slowdown in growth and escalating US-China trade tension had investors re-evaluating risk.

Rising long-term uncertainty led to a steepening in the VIX term structure in July and a renewed focus on hedging. Downside protection became a notable theme and while the VIX index hovered around year-to-date lows and VVIX neared 5-year lows, many investors were looking to VIX calls and SPX puts as cheap portfolio protection.

Further demand from retail investors to hedge downside risk was seen in volatility-linked ETPs. Average AUM in volatility-linked ETPs increased 42% in the second quarter, averaging $3.7 billion versus $2.6 billion in the first quarter.

A significant portion of this increase came from the continued growth of ETPs based in the APAC region. This contributed to a quarter-over-quarter increase in VIX futures open interest and VIX futures volume during Global Trading Hours.

Expanding our global footprint continues to be a main focus and I am happy to report that in June we received jurisdictional approval in Switzerland allowing Swiss trading privilege holders direct market access to CFE. Direct market access is an important step in increasing accessibility to our products in regions outside the US.

Turning to XSP. Our mini-SPX options contract, which is one-tenth the size of SPX and the same size as SPY, continues to demonstrate the value of our SPX product suite. Q2 2019 ADV is up 119% from Q1 2019 and up 314% from Q2 2018. Demand continues to build from investors looking for the increased risk management granularity provided by a smaller notional contract.

Both jurisdictional approval and the growth in XSP are a direct result of customer feedback as we continue to focus on the needs of our customers with the goal of providing solutions for all of their risk management needs.

Turning now to the U.S. equities market. I'm pleased to note that Adam Inzirillo, a longtime veteran of U.S. equities trading, is joining Cboe to head our U.S. equities business, which at present is a very dynamic segment of our company.

In our last earnings call we described our plans to increase trading on Cboe EDGX exchange with fee changes aimed at attracting additional order flow and with the introduction of execution priority to retail limit orders. I'm pleased to note that after the implementation of some recent fee changes, our U.S. equities market share rose above 17 percent in July from 15.7 percent in the second quarter, and we are prepared to launch retail priority on EDGX, pending regulatory approval and customer readiness. Both changes are designed to benefit individual investors and make EDGX the go-to place for retail trading.

Now turning to European equities, where overall market volumes were lighter during the second quarter compared to the previous year's quarter. We believe the lower volatility globally, compounded with the shifting political and regulatory landscape in light of Brexit left many market participants on the sidelines.

Brexit preparations remain a top priority. In light of the ongoing political developments, we have shifted our strategy to ensure we are well prepared for any potential political and regulatory outcome. In May, we announced plans to launch our Dutch venue on October 1st with all European Economic Area (EEA) stocks available for trading. Additionally, our UK venue will continue to trade UK, as well as EEA stocks.

This week we announced plans to launch Cboe Closing Cross (3C), a new post close trading service that will bring valuable competition to the post close trading session in Europe. The new service is scheduled to launch on August 16th and will serve as a cost-effective, one-stop shop for customers to execute their post close trading activities across 18 European markets.

Much as our Cboe Market Close (CMC) proposal was developed in response to customer demand for an alternative closing auction in the U.S. equities market, European market participants have also long expressed a need for a trading alternative given their increasing closing auction costs and volume. We are pleased that Cboe Closing Cross will bring much-needed choice and competition to this growing segment of the European market, and we are prepared to bring similar benefits to U.S. equities markets through Cboe Market Close, pending regulatory approval.

Turning now to technology, we are now nearing the planned completion of our migration of all Cboe exchanges to Bats technology on October 7th, which will allow us to maximize our value proposition by providing a superior, unified trading experience across all our equities, options and futures markets.

The completion of the migration is expected to also provide our customers with a more efficient and user-friendly trading experience that includes greater bandwidth, significant latency reduction, enhanced risk controls and improved complex order handling.

Just as we have with every successful phase of the migration to date, we continue to work very closely with our customers on the integration of our C1 exchange and remain laser-focused on the execution of a seamless technical and operational integration of this final platform migration.

Completion of this major undertaking not only enhances our efficiency and value proposition, but will also enable us to focus the considerable talent of our technology team on new growth initiatives. One such initiative is the development of a state-of-the-art research and data platform that we believe will help fuel the long-term growth of our company.

We intend for the new platform to combine data derived from existing Cboe assets with new functionality created in-house to glean actionable trading insights for our customers across all of our business lines.

This is a very exciting project for our team and one that leverages unique Cboe strengths -- technology, research and product development -- to provide tailored trading strategies for our customers and to inform the creation of new Cboe proprietary products.

We view the platform as a natural area of innovation for us and we look forward to moving from concept to design-and-build phase upon the completion of the C1 migration.

In closing, I would like to thank our team for the progress made throughout the second quarter in laying the foundation for future growth. We continued to tackle market-defining initiatives as we rolled out unique equity trading services, made headway on the final migration of all of our markets onto a unifying state-of-the-art platform, expanded our global footprint, and began design of a unique research and data platform, all of which we believe will create growth opportunities going forward.

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

Brian Schell Title Slide

Thanks Ed. And good morning, everyone.

Before I begin, I want to remind everyone that unless specifically noted, my comments relate to 2Q19 as compared to 2Q18 and are based on our non-GAAP adjusted results. Overall -

- Our net revenue was relatively unchanged, with:
  - net transaction fees down 1%, and
  - non-transaction revenue up 1%;
- Adjusted EBITDA grew 3%, with margin increasing 230 basis points to 68.4%;
- And finally, our adjusted diluted earnings per share increased 8% to $1.13.

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 business segment.

Our recurring revenue stream of proprietary market data and access and capacity fees, combined, increased 6% in the quarter and 8% year-to-date compared to the same periods last year, in line with our expectation for mid-to-high-single digit growth 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 two-thirds of the growth this quarter was the result of incremental subscriptions and nearly 100% of the growth of our access and capacity fees was also attributable to incremental units.

Now I'd like to turn to our segments.

In our options segment, the 3% or $4 million increase in net revenue was primarily driven by higher revenue in market data and access and capacity fees, with non-transaction fees up 10%. Net transaction fees in options were flat, with index options up 2%, offset by a 9% decrease in multi-listed options. Index options average daily volume (ADV) was up 6% for the quarter, offset somewhat by a 2% decline in RPC. The RPC decrease was primarily due to a mix shift – with mini-SPX options accounting for a higher percentage of volume. In our multi-listed options, ADV was up slightly but RPC was down 8%, reflecting higher volume-based rebates.

Turning to futures, the 4% or $1 million increase in net revenue resulted from a 7% increase in RPC on relatively flat ADV. The higher RPC year-over-year primarily reflects the impact of new pricing implemented in the later part of 2018 as well as lower volume-based rebates.

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 an increase in access and capacity fees. The lack of growth in net transaction fees reflects flat industry ADV and lower market share, offset by higher net capture.

SIP market data revenue fell 14% in the quarter while our proprietary market data revenue was up 1%. SIP revenue fell due to lower market share, as well as a decline in audit recoveries versus last year's second quarter.

Net revenue for European Equities decreased 4% on a U.S. dollar basis, primarily reflecting the unfavorable impact of foreign-currency translation. On a local currency basis, net revenue was up 1%, reflecting a 6% decrease in transaction fees offset by a 14% increase in non-transaction revenue. The growth in non-transaction revenue reflects increases in access and capacity fees and other revenue, which includes licensing and trade reporting revenue. The decline in net transaction fees was due to lower market volumes and market share, offset somewhat by favorable net capture. The higher capture resulted from continued strong periodic auction and LIS volume.

Net revenue for Global FX decreased 10% this quarter, reflecting a 15 percent decline in market volumes offset somewhat by higher net capture, which was up 4 percent primarily reflecting the impact of fee changes made in 2018. In addition, we grew market share to 15.2%, up nearly 30 basis points year-over-year.

Before I move to adjusted operating expenses, I'd like to point out two acquisition-related expenses incurred in the second quarter, which are included in non-GAAP adjustments. First, we classified our Chicago headquarters location as property held for sale, and based on our valuation analysis, recorded an impairment charge of $6.1 million. The marketing of our headquarters building and planned relocation is a result of a reduction of Cboe's employee workspace requirements in Chicago post the Bats acquisition and is projected to be completed in the second or third quarter of 2020.

Second, based on an anticipated restructuring of Cboe Vest, we recorded an impairment charge of $10.5 million. We are in the process of negotiating a sale of a majority of our shares in Vest, which would result in Cboe's ownership changing from 60% to approximately 25%. Please note that there are no assurances that the potential transactions will ultimately occur.

Turning to expenses, total adjusted operating expenses were just over $103 million for the quarter, down 3% versus last year's second quarter. The key expense variance was in compensation and benefits, primarily resulting from a decrease of over $6 million in incentive-and equity-based compensation and about a $2 million decrease in wages and payroll taxes; offset somewhat by an increase of about $4 million in deferred compensation plan expense. The decline in incentive-based compensation is aligned with our year-to-date financial performance.

The deferred compensation expense is directly offset by deferred compensation income reported in other income, so there is no impact to net earnings. This expense or income is based on the change in valuation of our deferred compensation plans.

As a result of the year-to-date decrease, primarily in compensation and benefits relative to our original expectations, we are adjusting our full-year 2019 expense guidance to be in the range of $405 to $413 million, down $10 million from our previous guidance range.

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 of our business. We plan to continue to invest in enhancing our customer facing business development team to drive greater engagement in our proprietary products, as well as, the development of an enhanced research and data platform, which Ed referenced previously.

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.

Turning to income taxes, our effective tax rate on adjusted earnings for the quarter was 27.7%, below our prior guidance of being at the higher end of the annual guidance range of 27% to 29% and lower than last year's second quarter rate of over 29%. The tax rate decrease was primarily due to excess tax benefits related to equity awards.

We are reaffirming our full year tax rate on adjusted earnings guidance to be in a range of 27 to 29%, but we now expect the rate to be at the lower end of the 2019 guidance range.

We are also reaffirming our guidance for depreciation and amortization and capital spending. For capital spending, we now expect to be at the lower end of our guidance range of $50 to $55 million, reflecting a shift in the timing of certain expenditures associated with our pending headquarters relocation.

Turning to capital allocation, we remain committed to a disciplined and balanced capital allocation strategy that includes reinvesting in our business, complementing our organic growth with potential acquisitions, and providing steady distributions to our shareholders through dividends and opportunistic share repurchases in order to maximize shareholder value.

During the second quarter, we returned nearly $35 million to shareholders through dividends and earlier this week our Board increased our third quarter dividend by 16% to $0.36 per share from $0.31.

In addition, we utilized cash on hand to repay the $300 million Senior Notes, which matured on June 28, 2019. Our debt now stands at $925 million and we have $250 million in availability under our revolver, if the need arises. At quarter end our leverage ratio stands at 1.2 times, down from 1.5 times at the end of the first quarter. We ended this quarter with adjusted cash of nearly $136 million.

Our remaining share repurchase authorization and the third quarter dividend increase reinforce our continued commitment to returning capital to shareholders and to increasing shareholder value. We remain committed to maintaining an investment grade balance sheet and strong financial position that enables us to continue to make prudent investments in our business to drive long-term profitable growth.

In summary, Cboe is executing on its strategic initiatives and setting the stage for both short-term and long-term performance with our continued 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 an increased quarterly dividends and potential 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 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 Global Markets, Inc.; 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.

Trademarks:

Cboe®, Cboe Global Markets®, Bats®, BZX®, BYX®, EDGX®, EDGA®, Cboe Volatility Index® and VIX® are registered trademarks and SPX℠ is a service mark of Cboe Global Markets, Inc. and its subsidiaries. All other trademarks and service marks are the property of their respective owners.