Cboe Global Markets, Inc.
Third Quarter 2019 Earnings Call - Prepared Remarks
November 1, 2019

Debbie Koopman

Good morning and thank you for joining us for our third 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 third 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 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.

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 third quarter 2019 at Cboe Global Markets, where we continued to focus on executing our strategic initiatives to drive long-term growth, including the migration of Cboe Options Exchange (Cboe) to our proprietary technology. That migration, which marked the final step in our company's multi-exchange technology integration, was completed on October 7th.

The successful completion of the integration provides our customers with a single, world-class trading experience across our markets, enhancing our value proposition for customers and shareholders alike.

This major step forward also enables us to redirect our technology efforts toward accelerating our organic growth as we pivot from integration to building new technologies, including the development of a state of-the-art research and data platform, and enhancing the global distribution of our products.

We're grateful to our customers for their loyalty and assistance. I thank them for working with us throughout this major effort. In return, we are committed to continually upgrading our technology to meet their evolving needs and to provide them with unparalleled service.

With that, I will turn to an overview of the trading and volatility landscape, with an update on strategic growth initiatives to increase trading in our proprietary products.

Equity markets remained strong and volatile in the third quarter as ongoing global growth concerns continued. The Federal Reserve responded with rate cuts in July, September, and earlier this week but, in each instance, remained noncommittal regarding further easing going forward.

We believe this uncertainty, combined with the lack of concrete plans to resolve the US-China trade war continued to drive hedging activity.

Index options and futures volume at Cboe climbed higher in the third quarter. Index options volumes rose 13% year over year, led by a 23% increase in VIX options trading and a 6% increase in SPX options. SPX Flex open interest also hit a new all-time record high of more than 925,000 contracts. Cboe created flex options to provide investors with a customizable way to manage risk and a centrally-cleared alternative to the OTC market.

Options-based strategies used by mutual funds and ETFs continue to be a key growth driver. According to Morningstar data, assets under management tied to options-based strategies hit a record $22 billion at the end of August, an increase of 24% this year, and is on track for one of the biggest advances of the past decade.

Looking ahead in index options trading, we responded to customer demand by adding Monday expiring options to XSP, our mini-SPX contract, which provides our customers with a smaller notional contract able to address their more granular risk management needs. In addition, we listed October 20th and November 20th Friday SPX options expirations, providing greater precision around options positioning going into the 2020 Presidential election. Open interest grew to over 30,000 contracts in

Turning now to 3Q19 VIX futures volume, which increased 19% year over year, primarily driven by robust volumes in August and continued growth in the volatility-linked ETP complex. Volatility-linked ETP AUM reached $4.8 billion in early October, its highest level since January 2018, and continues to be driven by growth in both long and leveraged long funds. Long and leveraged long AUM represented over 90% of total AUM versus its previous high of just under 40 percent in January 2018.

Education and client outreach is key to increasing trading in and expanding the customer base for all of our proprietary products. In September we hosted our 8th annual European Risk Management conference, held this year in Munich. The event drew a near record number of participants from 16 countries to explore the latest in derivative strategy and risk management. Industry experts delivered over 20 different presentations with themes ranging from how changes in margin and capital requirements will affect portfolios, to how institutional investors use option strategies to manage risk.

Organic growth remains our primary focus. We continued to evolve our sales and coverage teams, including adding top industry talent to better address our clients' needs and deliver best-in-class risk management solutions.

Now turning to European equities. As announced this morning, Mark Hemsley, President of Cboe Europe, is expected to retire at the end of February 2020, after 11 successful years at the company. Mark's many contributions include positioning Cboe Europe for future success by establishing a strong team of trading, technology and capital markets experts. While Mark remains at Cboe for several more months, I would like to take this opportunity to offer my sincere thanks for his outstanding leadership, deep industry expertise and valued counsel.

Dave Howson, currently COO of Cboe Europe, is expected to succeed Mark. Since joining the company in 2013, Dave has worked closely with Mark to shape and drive our Europe strategy and has been the driving force behind many of our successful product launches and technology initiatives. Dave's appointment is part of a long-established succession plan and he has the full support of the Cboe Global Markets board and management team.

In other Cboe Europe developments, we recently launched our Netherlands-based trade reporting facility and trading venue to provide customers with an EU venue to conduct equities trading and trade reporting activities for European Economic Area (EEA) stocks. Our fully operational Dutch venue enables us to continue to service our pan-European customer base should future political and regulatory developments hamper cross-border equity trading, while also positioning us to further expand our business.
While overall European equities volumes remained light in the third quarter, closing auction volume continued to rise in Europe. In response, this past August we launched Cboe Closing Cross, which we designed to bring needed competition to the post-close trading session. The new service is intended to provide a cost-effective, one-stop solution for customers looking to execute their post-close trading activities across 17 European markets.

In closing, I would like to thank our team for the progress made throughout the third quarter in laying the foundation for our company's ongoing growth. Their ability to successfully conclude a massive technology integration and upgrade, on time and with little-to-no disruption to our customers, is to be commended. Our unique and expansive product set now trades on one world-class platform. With this foundation in place, we are redoubling our efforts to mine the considerable opportunities we see for continued organic growth at Cboe Global Markets. We will leverage our technology, an efficiently focused sales force, and a new initiative to revamp our educational efforts, to expand our customer reach, to set new standards in trading resources and – with our customers – to define the marketplace of tomorrow.

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 3Q19 as compared to 3Q18 and are based on our non-GAAP adjusted results. Overall -

- Our net revenue was up 9%, with:
  - net transaction fees up 7%, and
  - non-transaction revenue up 11%;
- Adjusted EBITDA rose 15%, with margin increasing 380 basis points to nearly 71%;
- And finally, our adjusted diluted earnings per share increased 22% to $1.29.

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.

A consistent theme for Cboe this year has been the growth of our recurring revenue stream of proprietary market data and access and capacity fees. Combined, they increased 6% in the quarter and 7% 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 the completion of our technology migration will provide additional revenue opportunity over the long term. As it relates to proprietary market data, about 75% of the growth this quarter was the result of incremental subscriptions and nearly 85% 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 10% or $13 million increase in net revenue was primarily driven by growth in net transaction fees and market data fees, with non-transaction fees up 10%. Index options average daily volume (ADV) was up 13% for the quarter and RPC was up 2%, with the latter reflecting a change in mix within our SPX products. In multi-listed options, a 15% increase in ADV was offset by an 18% decline in RPC, reflecting higher volume-based rebates as our market share moved up over 200 basis points year-over-year and 130 basis points compared to second quarter 2019, driven by increased member order flow.

Turning to futures, the 28% or $8 million increase in net revenue primarily resulted from a 17% increase in ADV and a 2% increase in RPC. 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. Futures revenue also included $2.7 million from incremental equity received as a result of an agreement with American Financial Exchange related to the launch of AFX futures on CFE. This income was included in other revenue and is not expected to be a recurring item.

Turning to U.S. Equities, net revenue was up 6% or $4 million, primarily due to higher SIP market data revenue, as a result of audit recoveries of a similar amount. This increase was offset somewhat by a decrease in net transaction fees, resulting from a 23% decline in net capture on flat matched ADV. The net capture decline reflects fee changes implemented in the second quarter, aimed at capturing additional market share. Market share for the third quarter increased to 17.2% from 15.7% in second quarter of 2019 and was down slightly from last year's third quarter.

Net revenue for European Equities decreased 7% on a U.S. dollar basis, reflecting the unfavorable impact of foreign-currency translation and lower market volumes. On a local currency basis, net revenue was down only 2%, reflecting a 13% decrease in transaction fees offset somewhat by a 16% 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. We attribute a portion of the lower volumes and market share to the ongoing uncertainty around the timing and final outcome of Brexit and Swiss equivalency.

Net revenue for Global FX decreased 4% this quarter, reflecting a 12 percent decline in market volumes offset somewhat by a 7% increase in net capture, primarily reflecting the impact of fee changes made in 2018. In addition, market share of 14.1%, was down 70 basis points year-over-year.

Turning to expenses, total adjusted operating expenses were about $97 million for the quarter, down 3% versus last year's third quarter. The key expense variance was in compensation and benefits, primarily resulting from a decrease in incentive- and equity-based compensation. The decline in incentive-based compensation is aligned with our year-to-date financial performance versus targeted performance.

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 $390 to $395 million, down $15 to $18 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, among other things:

- achieving our targeted incentive compensation in 2020;
- the absence of approximately $6 million in favorable expense adjustments in 2019;
- transitioning to our new corporate headquarters in 2020 and moving our trading floor in 2021;
- the benefit of the synergies expected to be realized in 2020 from the C1 migration; and
- the continuation of investing to support our organic growth initiatives, which Ed referenced previously.

We plan to finalize our 2020 expense guidance on our next earnings call once we have completed our 2020 business plan, including any potential negative P&L impact from the amount of software development expensed versus capitalized.

With the final technology migration complete, we are reaffirming our run-rate expense synergy targets with a high degree of confidence. Chris Isaacson and his team concluded the technology migration in line with the updated plan established in May of 2018. We expect to exit 2019 with $80 million of run-rate synergies and exit 2020 with $85 million. Note that the remaining $5 million of run-rate synergies in 2020 will be reflected in a reduction in cost of revenues versus expenses.

Turning to income taxes, our effective tax rate on adjusted earnings for the quarter was 24.1%, below our prior guidance and lower than last year's third quarter rate of 26.4%. The tax rate decrease was primarily due to benefits related to tax reform and recognized upon the completion of our 2018 U.S. federal income tax return.

We are adjusting our full-year tax rate on adjusted earnings guidance to be in a range of 25.5% to 27.5%, down from 27% to 29%.

We are also adjusting our guidance for capital spending to $35 to $40 million, down from $50 to $55 million, due to a shift in timing for leasehold improvements associated with our Chicago headquarters relocation. We now expect those dollars to move into 2020. Furthermore, we are reaffirming our guidance range for depreciation and amortization of $35 to $40 million for 2019.

Before I review our capital allocation activities, we discussed the potential sale of our headquarters building in our last earnings call. I'd like to note that the cash proceeds from the potential sale is expected to be less than $30 million and are not likely to be received until sometime in 2021.

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

During the third quarter, we returned over $40 million to shareholders through dividends and $52 million through share repurchases. Furthermore, earlier this week our Board increased our share repurchase authorizations by $250 million. Including this new authorization and share repurchases of over $55 million in October, we had approximately $313 million of share repurchase authorization available at October 30, 2019.

During the quarter we also used $50 million to reduce debt under our term loan agreement. Our debt now stands at $875 million and we have $250 million in availability under our revolver, if a short-term funding need arises.   At quarter end, our leverage ratio stands at 1.1 times, down from 1.2 times at the end of the second quarter and we ended the quarter with adjusted cash of $151 million.

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
- Leveraging our freed up technology resources to focus on organic growth initiatives
- Disciplined expense management to leverage the scale of our business
- 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 dividends and opportunistic 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 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; 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: