Cboe Global Markets, Inc.
Fourth Quarter 2019 Earnings Call - Prepared Remarks
February 71, 2020

Debbie Koopman, V.P. Investor Relations

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 2019 financial results and 2020 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 fourth quarter 2019 at Cboe Global Markets. Lower volatility throughout the quarter was reflected in year-over-year declines in trading industrywide. The comparisons were especially challenging in our proprietary products, due to exceptionally strong trading in the fourth-quarter 2018. Despite the unfavorable trading conditions, I am pleased to note that in the fourth quarter and throughout 2019 we significantly strengthened our foundation for growth in 2020 and beyond.

We completed our technology migration while delivering on our synergy targets, expanded our offering of unique trading and educational resources, and launched new initiatives, such our plan to acquire EuroCCP and build out pan-European derivatives trading and clearing. And, just this week, we acquired Hanweck, a real-time risk analytics company, and the business of FT Options, a portfolio management platform provider. As a result, we believe we are better positioned to grow our business and to define markets globally to deliver value to our customers and shareholders.

Collectively, our team is excited to execute from this enhanced competitive position in 2020. I will highlight our upcoming initiatives today, first touching on recent market conditions.

The fourth quarter capped another year of tremendous stock market growth. The market continued to grind higher, ending up roughly 10 percent for the quarter and more than 30% year-over-year, marking one of the best performances in the past two decades and sparking debate over how much upside remains. Thus far in 2020, geopolitical tensions with China and Iran, an aging global expansion, the March primaries and November presidential election, and a potentially global pandemic loom over the economy.

As market unknowns increase, we see a greater focus on hedging and risk management. The need for more precision in positioning for potentially significant market events has been a consistent theme from our customers. In response, we provided them with added granularity by accelerating the listing of new terms in both SPX options and VIX futures and options, and have already begun to see growing trading in the new contracts.

In fact we saw stronger trading across the board in January, with increases in ADV month-over-month and year-over-year for SPX options and VIX futures. We had a record month for ADV in XSP options and saw our third highest monthly ADV of all-time in multi-listed options.

Turning now to our 2020 strategic initiatives. Our goal is to define markets by being the global leader in innovative tradable products and services. We are focused on the following initiatives aimed at reaching that goal:

- Strengthen our proprietary products and services
- Pursue leveragable derivatives methodologies
- Engage customers via information solutions
- Relentlessly focus on technology leadership
- Expand our global access and distribution
- Create capital efficiencies for customers

These initiatives reflect the considerable opportunity we see for organic growth, particularly in our proprietary products. Our recent acquisitions enable organic growth and reflect our M&A philosophy, which includes targeting acquisitions that have the potential to accelerate geographic and asset class presence, while deepening buy side connectivity and channel distribution.

We believe our planned acquisition of EuroCCP, a leading pan-European equities clearing house, significantly advances our strategic approach in Europe. We expect EuroCCP to enable us to grow our current European business, to further diversify our revenue stream and to launch a European derivatives business that leverages our expertise to better serve our global customer base. Additionally, as an EU-located clearinghouse, we believe EuroCCP provides us with strategic flexibility in light of the political and regulatory uncertainty surrounding Brexit and the future framework of European capital markets.

We see considerable head room to grow the European derivatives market, which currently lacks many efficiencies seen in the U.S. market. Customers are looking for a vibrant, on-exchange alternative, which we intend to provide through the creation of unique derivatives products and a more liquid, transparent and competitive marketplace.

On the product front, we expect to offer exposure that represents multiple European markets through European index futures and options and to explore potential single-name futures and options, ETP futures and options, OTC instruments and volatility derivatives. We expect the deal to close in the first half of this year, pending regulatory approval, and we look forward to officially welcoming the EuroCCP team to Cboe Global Markets.

This week's announced acquisitions of Hanweck and the business of FT Options represent a significant step forward in our ability to drive trading in our markets.
Hanweck and FT Options are profitable, best-in-class companies in the fast growing financial market data sector. Both companies will integrate with Cboe Information Solutions, which offers a broad suite of data solutions, analytics and indices to help market participants better understand and navigate our products and markets.

I'll note here that Cboe Information Solutions is separate and distinct from the planned research and data platform we discussed in previous calls. Our research and data platform will be built in-house and is intended to be internally focused, providing us with data, trends and insights into trading across our markets.

Information Solutions is external in nature, providing real-time tools for customers throughout the trading process. Officially just over three years old, the seeds were planted for Information Solutions with our 2015 acquisition of LiveVol, which was our first step in building out client-serving derived data and analytics products. In 2017 we acquired Silexx, which along with LiveVol and Cboe Global Indices, formed Information Solutions.

Our two new acquisitions bring complementary derived data products and services to Information Solutions, making it a truly comprehensive offering designed to optimize the customer experience throughout the life cycle of a transaction -- from pre-trade to at-trade and post-trade -- by providing insights, alpha opportunities, portfolio optimizations, risk management clarity and execution services.

With the added capability to help clients evaluate portfolio risk throughout all phases of trading, we expect Information Solutions to drive increased participation in our proprietary products and to attract new users to our marketplace. This week we welcomed the Hanweck and FT Options teams to Cboe and we look forward to working with them going forward.

Turning now to capital efficiency, which represents an opportunity for increased trading in our products and, because of its considerable importance to our customers, is an area in which we are deeply committed to customer advocacy.

In 2019, we, along with the support of our colleagues at OCC, began the necessary work to advocate for the expansion of customer portfolio margining to include more of our proprietary products. This is a considerable undertaking which would permit the inclusion of a VIX futures contract within a securities account for the purpose of portfolio margining. The inclusion of futures is expected to benefit customers that use VIX and SPX options by increasing margin efficiencies. We are in the initial stages of a long process requiring coordination among OCC, Cboe, and numerous regulatory bodies, and are committed to seeking to expand the availability of our products through this important initiative.

We continually evaluate execution costs, depth of liquidity, and capital requirements, improving them where we are able in order to maximize the efficiency of the hedging tools we provide to investors.

We believe that our proposed customer portfolio margining program will increase capital efficiencies and thereby expand trading opportunities. Further, we think that allowing customers to more effectively deploy capital will benefit the entire market by increasing liquidity within the larger financial system.

Another advocacy initiative of note was our recent publication of Cboe's Vision for Equity Market Structure Reform, which codifies our key recommendations for equity market reform, including that SIPs be implemented in multiple locations in order to reduce geographic latency. We think the recommendations we put forth are achievable and will generate consensus. We will remain both proactive and open-minded in responding to the ongoing process resulting from the SEC's proposal on SIPs and any other market structure matter.

In addition to our advocacy work, we are committed to enhancing the customer experience in the U.S. equities market through innovative products and services. We were gratified to receive final approval last month from the SEC to introduce Cboe Market Close (CMC).

As you know, we worked closely with customers to develop CMC in order to provide opportunities for cost benefits amidst one of the most critical liquidity events of the trading day. We and our customers have long looked forward to our ability to provide opportunities for cost efficiencies at market close. We are working closely with customers and, subject to their readiness, plan to launch CMC on our BZX Exchange on March 6th.

In closing, I would like to thank Mark Hemsley, who retires as head of Cboe Europe this month. Our entire organization is grateful for Mark's vision, leadership and dedication, which created a culture of success at Cboe Europe. Cboe and industry veteran Dave Howson succeeds Mark, in what has been a seamless transition, leaving Cboe Europe well poised for continued success. We thank Mark for his service and wish him well in his retirement.

I would also like to thank the entire Cboe team for their successful execution of key growth initiatives in 2019, which enhanced our competitive position and better enabled us to serve and grow our global customer base. Furthermore, our team came out of the gate in 2020 with strong forward momentum, already leveraging the success of our newly integrated trading technology, closing two pivotal acquisitions, working closely with customers to quickly implement CMC, and embarking on an ambitious and well-orchestrated 2020 global marketing and education effort. As a result of their collective efforts, we are very bullish on all that we can accomplish in 2020.

With that I will turn it over to Brian.

Brian Schell, CFO

Thanks Ed. And good morning, everyone.

Before I begin, let me remind everyone that unless specifically noted, my comments relate to 4Q19 as compared to 4Q18 and are based on our non-GAAP adjusted results. As Ed noted, we had difficult comparisons given the record financial results we achieved in the fourth quarter of 2018, versus weaker trading volumes in 4Q19, overall:

- Our net revenue was down 16%, with:
    - net transaction fees down 30%, and
    - non-transaction revenue up 10%;

- Adjusted EBITDA declined 18%, but achieved a healthy margin of over 70%, compared to the record margin of nearly 72% in last year's fourth quarter;
- And finally, our adjusted diluted earnings per share decreased 21% to $1.21.

Throughout 2019, a consistent theme for Cboe was the growth of our recurring revenue stream of proprietary market data and access and capacity fees. Combined, they increased 7% for both the fourth quarter and the full year compared to the same periods in 2018, in line with our expectations for mid-to-high single digit growth. As it relates to proprietary market data, about 70% of the growth this quarter was the result of incremental subscriptions and nearly 85% of the growth of our access and capacity fees was attributable to incremental units. We continue to see opportunity across all of our asset classes and believe we can grow this revenue stream at low- to mid-single digits in 2020, on an organic basis. Note that this growth rate reflects the shift of approximately $4.5 million or 150 basis points, previously reported in access and capacity fees in 2019 to transaction fees in 2020. The primary revenue contribution from our acquisitions of Hanweck and FT Options is expected to result in additional market data revenue; thus on a reported basis, the reported growth rate is expected to be in the high-single digits. -- Now I would like to turn to our segments.

In our options segment, the 20% or $35 million decrease in net revenue was due to lower net transaction fees, particularly in our index options, offset somewhat by lower royalty fees and higher market data fees. Index options average daily volume (ADV) was down 31% for the quarter, while RPC was up 2%. The RPC lift reflects a mix shift, with SPX options representing a higher percentage of the overall index volume. In multi-listed options, ADV was down 8% and RPC fell by 34%, with the latter primarily due to a shift in volume mix by order type, and higher volume rebates versus the fourth quarter of 2018.

Turning to futures, the 24% or $9 million decrease in net revenue primarily reflects a 33% decrease in ADV, offset somewhat by a 6% increase in RPC and lower royalty fees. The higher RPC year-over-year was primarily due to lower volume-based rebates.

In U.S. Equities, net revenue was down 7% or $6 million, primarily due to lower transaction fees, a result of a 27% decline in matched ADV and a 15% decline in net capture. This decrease was offset somewhat by higher market data revenue and regulatory fees, with the latter driven by fines.

In the third quarter of 2019, we re-invested a portion of our higher than expected net capture to attract additional market share, which has shown mixed results as measured by total market share through the fourth quarter of 2019. However, Cboe's share of continuous trading has actually increased during the course of 2019 reflecting the impact of the pricing changes. The lower total market share reflects the increasing portion of volumes trading off-exchange and during the closing auction, where Cboe has not competed. With the upcoming launch of Cboe market close, we hope to be able to tap into part of the closing auction market volume, benefitting the industry with an on-exchange, price-competitive alternative.

Net revenue for European Equities decreased 11% on a U.S. dollar and a local currency basis, reflecting lower market volumes. The net revenue decline reflects a 28% decrease in transaction fees offset somewhat by a 20% 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 loss of ability to offer Swiss securities for trading due to Swiss equivalency issues. In addition, we continued to see a growing portion of volume trading off-exchange and in closing auctions, driven in part by the low market volume and muted volatility.

Net revenue for Global FX decreased 6% this quarter, reflecting a 14 percent decline in market volumes offset somewhat by a 6% increase in net capture, with the latter reflecting the impact of lower volumes on our tiered pricing. In addition, market share reached a new high of 16.0%, up 70 basis points year-over-year, primarily driven by positive customer response to our new full amount offering.

Turning to expenses, total adjusted operating expenses were about $96 million for the quarter, down 14% versus last year's fourth quarter. The key expense variance was in compensation and benefits, primarily resulting from a decrease in incentive-based compensation. The decline in incentive-based compensation is aligned with our full-year financial performance versus our targeted performance.

Additionally, I'd like to point out two expense items included in our non-GAAP adjustments in the fourth quarter: (1) a $23 million provision for notes receivable associated with the funding for the development of the consolidated audit trail or "CAT" and (2) a $4.5 million charge for the write-off of

Expense Guidance:

With respect to our 2020 expense guidance, we are updating our prior guidance of $420 to $428 million to a range of $435 to $443 million, reflecting our acquisitions of Hanweck and FT Options, announced earlier this week. Take note that this guidance does not include our planned acquisition of EuroCCP and the build out of pan-European derivatives trading and clearing. We plan to update our full-year 2020 guidance after the acquisition closes, which is expected to occur in the first half of this year, subject to regulatory approvals and other closing conditions.

This slide provides a bridge from our 2019 adjusted operating expenses to our 2020 guidance, detailing the key expense drivers:

- Core expense growth of 4% to 5%, in line with prior years, which reflects the continuation of investing to support our organic growth initiatives, which Ed referenced previously;
- an offset from expense synergies of about $18 million expected to be realized in 2020, primarily from the C1 migration;
- a full year of incremental cost for our Brexit readiness of about $3 million;
- the absence in 2020 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 is expected to result in $7 to $8 million in duplicate occupancy expenses in 2020; we expect these incremental cost to decline to about $3 million in 2021, with cost benefits starting to accrue in 2022;
- the impact of software development expensed versus capitalized of $7 to $8 million, reflecting the faster cadence at which we implement technology updates and a shift in the scale of our technology projects;
- the assumption that we will achieve our targeted incentive compensation in 2020, accounting for $10 to $12 million, and
- incremental operating expenses of approximately $15 million related to our acquisitions of Hanweck and FT Options.
- Arriving at our guidance for 2020 adjusted operating expenses of $435 to $443 million.

Additionally, as we disclosed previously, our pending acquisition of EuroCCP and the build out of pan-European derivatives trading and clearing are expected to reduce earnings per share by about $0.08 to $0.10 in both 2020 and 2021. About half of the estimated EPS impact in 2020 reflects the potential acquisition of EuroCCP, including incremental costs associated with a new €1.5 billion back-up line of credit. The remainder relates to our investment in building out the derivatives business. We expect EuroCCP to be neutral to slightly positive to earnings per share in 2021, as it builds on growth initiatives.

As you can see from this table, EuroCCP generated about €23.8 million in revenue in 2019, based on unaudited and preliminary results, up 12% vs. 2018 and generated positive net earnings. We are excited about the opportunity we see to grow the market for derivatives trading, particularly in options. While the U.S. and Europe have similar GDPs and wealth levels, the notional value of equity and index options traded in the U.S. is seven to eight times greater than the notional value traded in Europe.

With the final technology migration completed, we exited 2019 with $80 million of run-rate synergies and still expect to exit 2020 with $85 million. As noted on our prior earnings call, we expect most of the remaining $5 million of run-rate synergies in 2020 to result in a reduction in cost of revenues versus expenses, reflected in royalty fees.

2020 Tax Rate and Guidance

Turning to income taxes, our effective tax rate on adjusted earnings for the quarter was 24.7%, below our prior guidance but above last year's fourth quarter rate of 22.1%. The tax rate increase was primarily due to tax benefits associated with re-measuring our net deferred tax liabilities recognized in the fourth quarter of 2018.

Our 2020 full-year tax rate on adjusted earnings is expected to be in a range of 26.5% to 28.5%, versus 25.5% in 2019. The projected increase reflects a reduction in discrete tax adjustments in 2020 versus 2019.

Depreciation and amortization / Capital Spending

Capital spending in 2020 is expected to be $65 to $70 million, up from $38 million in 2019, primarily due to leasehold improvements and other costs associated with our Chicago headquarters relocation in 2020 and the trading floor move slated for 2021. Furthermore, we expect depreciation and amortization to be $34 to $38 million for 2020, compared to $38 million in 2019. This excludes amortization of intangibles of approximately $120 million in 2020 versus $139 million in 2019.

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 acquisitions, and providing steady distributions to our shareholders through increased dividends and opportunistic share repurchases in order to maximize shareholder value.

During the fourth quarter, we returned over $40 million to shareholders through dividends and $70 million through share repurchases. For the full year, we returned over $300 million to shareholders through dividends and share repurchases and through the first month of this year, we used nearly $27 million to repurchase our shares, leaving approximately, $273 million of share repurchase authorization available at January 31, 2020.

Our debt remains at $875 million and we have $250 million in availability under our revolver, if a short-term funding need arises. Our leverage ratio was 1.2 times at year-end, up from 1.1 times at the end of the third quarter, reflecting a slightly lower trailing twelve months of earnings, and we ended the year with adjusted cash of $208 million. The slightly higher cash balance reflects the anticipated funding of share repurchase activity in January and the recently announced acquisitions.

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
- Executing on our initiative of getting closer to our customers pre-trade, at-trade and post-trade, to drive volume
- Growing and diversifying 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, and
- A disciplined capital allocation plan focused on long-term shareholder growth.

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; 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.