Cboe Global Markets, Inc.
First Quarter 2020 Earnings Call - Prepared Remarks
May 1, 2020

Debbie Koopman

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 financial results and provide updated 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 would 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. Today's speakers are joining from different locations, so I would ask that you please be patient if there are any technical difficulties. Now, I'd like to turn the call over to Ed.

Ed Tilly, CEO

Good morning. I would like to thank you for joining us and to extend my best wishes for your health

The first quarter 2020 was a stunning period in history encompassing the nascent spread of the covid-19 virus to a global pandemic, threatening lives, markets and economies.

The growing spread of the virus fueled tremendous market uncertainty as well as concern for the health of our employees, market participants and communities. Our first priority was to help mitigate the risk of potential exposure to our team members and trading floor community, while working closely with our regulators and customers to maintain continuous and orderly markets.

We began transitioning employees to work from home ahead of government mandates and, on March 16th, we made the very difficult, but necessary, decision to temporarily close the trading floor for the first time in our 47-year history and transition Cboe Options Exchange to all-electronic trading.

Cboe's hybrid trading system has always provided best-in-class liquidity and access through open-outcry and electronic trading mechanisms. While the historic action of closing the floor proved to be a short-term distraction, thanks to the collaboration and input from our floor trading community and the responsiveness of our regulators, we were able to complete this transition in a two-day period. The SEC's collaboration and support was critical in enabling us to work quickly through the rule changes needed to close gaps through technology for a seamless transition.

Although it remains unclear when and how we may re-open the floor, we are in discussions with our trading floor community and working through various scenarios so we are well prepared for any eventuality. The health and safety of our trading floor community, which includes market participants and Cboe team members, is our highest priority and will dictate when and how we re-open the trading floor.

In the meantime, the electronic component of our hybrid system remains industry leading, and we are actively working on electronic solutions to replicate the benefits of floor trading in order to better respond to the demand for high risk and complex trades that are temporarily more difficult to satisfy. The recent market instability reconfirms the importance of transparent, accessible and regulated markets. Throughout this period of extreme market conditions, our exchanges performed without incident, processing dramatically increased volumes across all of our markets.

Turning now to a look at the recent trading environment. The S&P 500 index touched record highs in mid-February. With a variety of known unknowns on the horizon, combined with initial concerns around the impact and severity of the coronavirus, hedging was top of mind for most investors. As we have seen before, in the midst of extreme market uncertainty the world turns to Cboe to leverage the utility of SPX and VIX options and VIX futures to navigate market turbulence. This played out vividly in the first quarter 2020 with year-over-year increases of 43 percent in index options and 44 percent in VIX futures as investors repositioned and monetized hedges during the subsequent market selloff.

Higher trading volumes in the first quarter gave way to lower volumes across our proprietary products in April. As we look across our diversified product line, we continued to see strong volume in multi-listed options and U.S. Equities as users of our index products de-risked and regrouped.

Volumes will ebb and flow as uncertainty plays out. The extended disruption in the market has been colored by record levels in realized and implied equity volatility, while rates have collapsed and oil prices traded negative. Currently, as we have seen before during times of extreme market stress, investors de-risk until the event is more clearly defined. When they are better able to assess risk, they reengage. Tragically, this is an ongoing crisis, and we expect to see new permutations of volatility as it continues to evolve. No one can say with certainty how this situation will play out, but the path to recovery is unlikely to be linear. We expect investors to continue to deploy – and redeploy – our unique product set to trade their changing market views and hedge their positions as the crisis evolves.

We remain focused on listening to our customers by delivering products and solutions tailored to help them reposition to better navigate this new and extraordinary environment. We are actively redefining how we approach investor education. Two new initiatives include virtual forums for industry experts to share the latest in risk management strategies and webinars covering a broad range of topics designed to increase awareness about the benefits of allocating to Cboe products. Further, we are positioned to assist our customers by offering customized trading resources that address the complexity of managing risk through periods of heightened and prolonged uncertainty.

Silexx, Cboe's proprietary order and execution management system, continues to provide critical functionality throughout the challenges presented by the COVID-19 pandemic. In order to facilitate access in an all-electronic environment, we expedited development work on Silexx, which enabled floor traders to replicate their work streams in both Flex and listed options and remain active in the new virtual environment.

In addition, we offered Silexx free to our floor trading permit holders through the end of May to help them adjust and provide continuous liquidity. By facilitating access to our market in an all-electronic environment, we helped ensure the continuation of a fair and orderly marketplace.

Slide 9: Offer Comprehensive Suite of Data Solutions, Analytics and Indices

Along with the growing need for robust, customized tools, we saw increased demand for historical datasets and sophisticated analytics as the world tries to make sense of the current economic environment and prepares for what lies ahead. By offering a comprehensive suite of data solutions, analytics and indices, we provide market participants tools for better understanding risk and accessing Cboe markets.

Understanding risk has never been more important than now; it follows that portfolio risk and margin efficiency rank at the top of what our customers need. This highlights the importance and timeliness of our recent acquisitions of Hanweck, a real-time risk analytics company, and FT Options, a portfolio management platform provider.

Similar to our Silexx acquisition two and a half years ago, our Hanweck and FT Options acquisitions were based on our ongoing commitment to investing in tools to grow the utility of our product suite. The value of these investments may not manifest immediately, but eventually market conditions make clear how these resources draw users to our markets and help establish higher baselines of product volumes once participants re-establish their views on the market.

We also support customers through product innovation that delivers value in a variety of market environments. For example, in our U.S. equities business we are encouraged by the positive response we have seen to our new Retail Priority offering, with steady increases in ADV each month and representing about 5% of shares executed on Cboe EDGX in April. On March 6, we launched Cboe Market Close (CMC), which enables us to tap into part of the closing auction market volume, while benefitting the industry with an on-exchange, price-competitive alternative. As expected, the market environment during the quarter limited customer uptake of CMC, but we expect uptake to increase based on recent customer outreach for certification and testing. Meanwhile, our post close trading service in Europe, Cboe Closing Cross (3C), has begun to gain traction and we expect that volume to continue to build, as well.

In addition, Cboe BZX was the first exchange to list actively managed Semi-transparent ETFs for trading, leading the industry and supporting our issuers with the approval and listing of this ground breaking ETF innovation. With other listings of this type in the pipeline, we are focused on establishing Cboe as the listing venue of choice in this arena.

Turning to Europe, the close of the EuroCCP transaction remains on track and currently is expected to close in the next few months, pending regulatory approval and other closing conditions.

As we have mentioned, we expect EuroCCP to enable us to grow our current European business, to further diversify our revenue stream by enabling us to bring to market a European derivatives business that leverages our expertise in actively quoted markets to better serve our global customer base. EuroCCP is the central link in the pan-European equity market network, and we value the business for the critical role it plays in settlement across Europe.

Additionally, as an in-EU clearinghouse, we see EuroCCP as a strategic asset in light of the political and regulatory uncertainty surrounding Brexit and the future framework of European capital markets. We look forward to sharing additional details on our European derivatives launch plans in the coming weeks.

As a global exchange operator, Cboe is deeply committed to providing orderly markets throughout this crisis. I would like to thank our trading community and regulators for their critical work in enabling us to maintain robust and reliable markets during this critical time. I believe the highly collaborative efforts with our regulators throughout this crisis can serve as a model for productive collaboration going forward.

Special thank also to the Cboe team. Our associates are deeply experienced in the business of risk management, which requires prudence, knowledge, flexibility and composure - qualities in abundance across our team. Their collective experience and dedication enabled us to successfully navigate extraordinary short-term challenges, while continuing to execute strategic growth initiatives across all of our business lines.

“Good citizenship” is one of Cboe’s guiding principles, and we are also mindful of our role as a global corporate citizen, with offices and customers around the world. The giving spirit of our team is inspiring. Our companywide corporate giving and the generosity of our associates is focused on providing relief to those suffering from the crisis and to containing its spread.

We believe the experience of our team, our diversified product line, which includes but extends well beyond our unique proprietary products, and the expansion and growing utility of our customized trading resources leave us well positioned to continue to deliver positive results for our customers and investors as we move forward.

With that I will turn it over to Brian.

Brian Schell, CFO

Thanks Ed and good morning, everyone. I hope everyone and their families are remaining safe and healthy.

Let me remind everyone that unless specifically noted, my comments relate to 1Q20 as compared to 1Q19 and are based on our non-GAAP adjusted results. As Ed noted, we reported record financial results for the quarter, underscoring the strength and resiliency of Cboe’s franchise and the utility of our products, particularly in times of market turbulence:

- Our net revenue increased 28%, with:
    - net transaction fees up 43%, and
    - non-transaction revenue up 7%;

- Adjusted operating expenses increased just 5%, which combined with our strong revenue growth, resulted in adjusted EBITDA growth of 42%, resulting in a very healthy margin of over 74%;
- The Adjusted EBITDA margin on incremental net revenue was 103%;
- And finally, our adjusted diluted earnings per share increased 48% to $1.65. [PAUSE]

Consistent with our prior guidance, we grew our quarterly recurring revenue stream of proprietary market data and access and capacity fees by 8% compared to first-quarter 2019. This increase includes over $2 million attributed to the acquisitions of Hanweck and FT Options in the quarter. Organic growth was 7%, which excludes the acquisitions and the shift of approximately $1 million in revenue reported in access and capacity fees in 1Q19, which is now reported in transaction fees. The growth in proprietary market data and access and capacity fees continued to be driven by incremental subscriptions and units, accounting for about 86% and 77% of the growth this quarter, respectively.

In our last call, we noted our expectation that these revenues would grow in the low-to-mid-single digits organically and mid-to-high-single digits on a reported basis, which is inclusive of the acquisitions of Hanweck and FT Options. Looking ahead, the <u>reported</u> growth rate for these non-transaction fees is <u>now</u> expected to be lower – in the low-to-mid single digits - due to the realignment of certain fees as a result of our move to all-electronic trading. Certain floor broker access and capacity fees have been suspended due to the temporary floor closing. However, we have implemented comparable transaction-related fees in an attempt to achieve a neutral net revenue impact, all else remaining equal. Having said this, we remain optimistic about achieving the underlying organic growth target of the remaining proprietary market data and access and capacity fee category. This revenue shift will occur in the second quarter – again in the form of higher transaction fee revenue associated with higher RPC for our index options and lower access and capacity fees.

Now, a review of our segments.

In our options segment, the 36% or $50 million increase in net revenue was driven by growth in net transaction fees, particularly in our index options, where average daily volume (ADV) climbed 44% for the quarter and RPC grew 7%. The RPC lift reflects a mix shift by order execution and type, as well as pricing changes implemented during the quarter, most notably, a fee increase for SPX options (as well a fee decrease for VIX). In multi-listed options, ADV increased by 55% and RPC fell by 21%, with the latter primarily due to a shift in customer mix and higher volume rebates versus the first quarter of 2019.

Turning to futures, the 36% or $11 million increase in net revenue primarily reflects a 43% increase in ADV and a 1% increase in RPC. The higher RPC year-over-year was primarily due to a mix shift, with a greater percentage of volume coming from higher-RPC order types, including block trades.

In U.S. Equities, net revenue increased 14% or $11 million, primarily due to higher transaction fees, with equities volume benefiting from the return of volatility to the market, shifting more trading to on-exchange venues versus off-exchange. Our market share increased year-over-year and sequentially, and has been particularly strong on our Cboe BZX exchange, where we have benefited from the rise in ETF trading, a key volume growth driver in U.S. equities.

Net revenue for European Equities increased 15% on a U.S. dollar basis and 17% on a local currency basis, reflecting higher market volumes and higher capture, offset somewhat by lower market share. The higher capture resulted from continued strong periodic auction and LIS volume. The net revenue increase reflects a 17% increase in transaction fees and non-transaction revenue. The growth in non-transaction revenue reflects increases in access and capacity fees, primarily reflecting incremental connections with the opening of our Amsterdam network in October of 2019, and other revenue, which includes licensing and trade reporting revenue. The decline in market share was primarily a result of significant market profile shifts due to the highly volatile market conditions in the quarter which saw many participants recalibrate their models. Additionally, volumes were impacted by our loss of ability to offer Swiss securities for trading, due to the Swiss equivalency matter.

Net revenue for Global FX increased 22% this quarter, hitting a new all-time high, reflecting a 19% increase in market volumes and a 3% increase in net capture, with the latter reflecting a mix shift in volume by customer type. We maintained strong market share and set new ADV highs in our full amount offering as well as on Cboe SEF for NDF's.

Turning to expenses, total adjusted operating expenses were about $99 million for the quarter, up 5% against last year's first quarter. The key expense variance was in compensation and benefits, reflecting the net impact of:

1) a $5 million increase in incentive-based compensation, resulting from higher bonus expense this quarter and forfeitures of unvested equity awards in 1Q19;
2) a $2 million increase as a result of lower capitalized wages relating to software development; and
3) a $2 million decline in benefits due to the adjustment of deferred compensation plan assets. Note that there is an offsetting $2 million charge in other income, resulting in no impact to earnings. This adjustment reflects the change in the valuation of certain deferred compensation plan assets and we do not attempt to forecast or include as part of our overall expense guidance.

Expense Guidance:

Looking ahead to the remainder of 2020, while much uncertainty remains around how this pandemic plays out, we remain steadfast in our execution of prudent expense management. In light of the COVID-19 crisis, we have re-calibrated our 2020 expense plan with a focus on deploying our resources to have the greatest impact. We are reducing our guidance for 2020 adjusted operating expenses by $16 million to a range of $419 to $427 million, primarily reflecting lower compensation costs and lower expenses for travel and entertainment and marketing events, resulting from the current environment. Expenses are expected to ramp up in the second half of the year as we plan to accelerate our existing growth initiatives and complete our Chicago headquarters buildout. This slide provides an update to the 2019 to 2020 expense bridge we provided in our last earnings call, indicating that we now expect core expense growth to be flat to up 1% because of changes to our assumptions.

As a reminder, this guidance does not include our planned acquisition of EuroCCP and the build out of pan-European derivatives trading and clearing. We plan to incorporate that into our 2020 guidance after the acquisition closes, which we still expect to occur in the next few months, subject to regulatory approvals and other closing conditions.

2020 Tax Rate and Guidance

Turning to income taxes, our effective tax rate on adjusted earnings for the quarter was 27.0%, at the lower end of our guidance range but above last year’s first quarter rate of 25.4%. The year-over-year tax rate increase was primarily due to greater excess tax benefits associated with equity awards in the first quarter of 2019 versus 2020.

We are reaffirming our 2020 full-year tax rate on adjusted earnings, which is expected to be in a range of 26.5% to 28.5%.

Depreciation and Amortization / Capital Spending

We are reaffirming our capital spending guidance for 2020 of $65 to $70 million. We are still on track to move into our new Chicago headquarters in the early part of the third quarter, however, this could shift based on availability of our current suppliers. Furthermore, we still expect depreciation and amortization to be $34 to $38 million for 2020, which excludes amortization of intangibles of approximately $120 million in 2020.

Turning to capital allocation, let me underscore, we remain focused on investing in the growth of our business to build upon our strengths while returning excess cash to shareholders through dividends and share repurchases. Our financial position continues to be very strong; we have very good cash flow generation capabilities and a solid balance sheet. During the first quarter, we returned $120 million to shareholders through share repurchases and $40 million through dividends and at March 31, our share repurchase authorization available was $180 million.

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 moved to 1.0 times at quarter-end, down from 1.2 times at the end of the year, reflecting higher trailing twelve months of earnings; and, we ended the year with adjusted cash of $137 million. We expect to see approximately $25-30 million of a liquidity benefit primarily from the immediate deductibility of leasehold improvement expenses (for our Chicago headquarters move), deferral of first quarter tax payments and employer social security taxes as allowed by the U.S. CARES Act. We do expect to maintain a more conservative cash position in the near term and evaluate funding alternatives opportunistically.

In closing, these unprecedented times leave us with many unknows, but what we do know is:

1) we just reported record quarterly financial results across almost every financial metric;

2) our technology infrastructure handled messaging volumes that were double prior peaks, with no service disruptions;
3) we worked collaboratively with our regulators and trading floor community to migrate to an all-electronic exchange; and
4) our workforce converted to a work from home environment – all without skipping a beat.

The underlying fundamentals of our business are strong and our philosophy of maintaining financial flexibility is in place for times like these. Regardless of market conditions, we remain focused on serving the needs of our customers and delivering sustainable returns to our shareholders, while guarding the health and welfare of our associates.

With that, I will turn it over to Debbie, for instructions on the Q&A portion of the call.

Debbie Koopman

At this point, we would be happy to take questions. We ask that you please limit your questions to one per person to allow time to get to everyone. Feel free to get back in the queue and if time permits we'll take a second question.

Cautionary Statements Regarding Forward-Looking Information and Trademarks:

This presentation contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve a number of risks and uncertainties. You can identify these statements by forward-looking words such as "may," "might," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential" or "continue," and the negative of these terms and other comparable terminology. All statements that reflect our expectations, assumptions or projections about the future other than statements of historical fact are forward-looking statements. These forward-looking statements, which are subject to known and unknown risks, uncertainties and assumptions about us, may include projections of our future financial performance based on our growth strategies and anticipated trends in our business. These statements are only predictions based on our current expectations and projections about future events. There are important factors that could cause our actual results, level of activity, performance or achievements to differ materially from those expressed or implied by the forward-looking statements.

We operate in a very competitive and rapidly changing environment. New risks and uncertainties emerge from time to time, and it is not possible to predict all risks and uncertainties, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Some factors that could cause actual results to differ include: the impact of the novel coronavirus ("COVID-19") pandemic, including changes to trading behavior broadly in the market as well as due to the temporary suspension of open outcry trading in response to COVID-19; 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; 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, long-lived assets, 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, 2019 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.

This presentation includes market share, financials and industry data that we obtained from industry publications and surveys, reports of governmental agencies, third-parties and internal company surveys. Industry publications and surveys generally state that the information they contain has been obtained from sources believed to be reliable, but we cannot assure you that this information is accurate or complete. We have not independently verified any of the data and financials from third-party sources nor have we ascertained the underlying economic assumptions relied upon therein. Statements as to our market position are based on the most currently available market data. While we are not aware of any misstatements regarding industry data and financials presented herein, our estimates involve risks and uncertainties and are subject to change based on various factors.