Cboe Global Markets, Inc.
Third Quarter 2020 Earnings Call - Prepared Remarks
October 30, 2020

Debbie Koopman, VP Investor Relations

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, CFO and Treasurer, will provide an overview of our financial results and provide updated 2020 guidance. 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. Now, I'd like to turn the call over to Ed.

Ed Tilly, CEO

Good morning and thank you for joining us today. I hope everyone continues to remain safe and healthy as the pandemic continues to take its toll around the globe.

I am pleased to report solid financial results for the third quarter of 2020 at Cboe Global Markets, where we continued to advance our strategic growth plan to strengthen our product line across asset classes and geographies, broaden our customer reach, diversify our business mix with recurring revenue and leverage our superior technology.

Thanks to this ongoing disciplined approach, we were well positioned to navigate market conditions that left many institutional investors on the sidelines.

Much as we saw in the previous quarter, our third quarter results were driven by increased trading volumes in cash equities and multi-listed options, fueled by growth in retail trading. We also saw continued growth in our recurring proprietary non-transaction revenues.

Last quarter I highlighted our strategy to strengthen our U.S. equities business through new markets and new trading mechanisms, such as retail priority and periodic auctions.

Growing retail participation helped drive a 26 percent year-over-year increase in U.S. equities trading for the quarter. Volume in Retail Priority orders, which we launched last year on Cboe EDGX, represented nearly 23 percent of total volume and helped propel the exchange to record market share last quarter of 6.8 percent.

We believe we are uniquely positioned to define the state-of-the art in equities trading through product and market innovation. We took significant steps toward realizing that vision with the third quarter completion of our acquisition of MATCHNow and with our recently announced plans to acquire BIDS Trading.

MATCHNow, you will recall, is Canada's largest Alternative Trading System (ATS). I'm pleased to say we are well on track with its integration, which enables us to expand our equities offering, achieve incremental scale and reach new market participants. Importantly, we also see MATCHNow as a toehold in the Canadian market for additional Cboe products and services.

We were delighted this month to announce our planned acquisition of BIDS Trading, which is expected to provide us with a meaningful presence in the substantial off-exchange U.S. equities market. We've received great feedback on the deal from our customers and we couldn't be more excited about the opportunities ahead in this growing space.

Our successful and innovative partnership with BIDS Trading began in 2016 with the launch of Cboe LIS, now one of the largest block trading platforms in Europe. We've since enjoyed a collaborative and fruitful relationship with Tim Mahoney and the entire BIDS team and are pleased they will remain part of the Cboe family. While BIDS will continue to operate as an independently managed venue separate from our U.S. securities exchanges, we have great faith in their expertise and ability to execute on our shared vision once the deal is approved.

Similar to MATCHNow, we view the value of the BIDS transaction in terms of the significant new dimension it brings to equity trading at Cboe and for how it enables us to grow our entire product ecosystem. In addition to expanding our equity trading market and customer base, the acquisition of BIDS and its leading block trading platform provides opportunities for us to bring off-exchange trading and services to other products and geographies, including Canada.

Turning now to multi-listed options trading. This is a fitting point for me to take a moment to note the passing of Joe Sullivan, Cboe's founding President. His tireless advocacy for a listed options market helped launch Cboe and, with it, the entire options industry 47 years ago. Joe was an amazing visionary and I echo my condolences to his family here on behalf of our entire company.

Cboe has since become known for other products and services, but we have always remained committed to being a leader in the equity options space. Our recent initiatives have focused on accessing and engaging the broad market through our acquisitions of Hanweck, FT Options and Trade Alert; the expansion of our Options Institute offering; and the introduction of products for sophisticated retail market participants.

In the third quarter, retail trading led the way to a 46-percent increase in equity options trading at Cboe with smaller, short-term positioning trades. Each of our four options exchanges saw year-over-year increases in average daily volume. Zero broker commissions and free trading apps ushered in a new generation of retail traders, who continue to contribute to record volumes in 2020.

Conversely, market uncertainty continues to dampen institutional trading.

The ripple effects of the Covid-19 virus continue to be felt as the economy looked to stabilize during the third quarter. Businesses reopened and consumers slowly began resuming some semblance of typical activity, but the path forward was and still is marked with massive uncertainty. The lack of progress in negotiations to extend fiscal stimulus programs, combined with the risk of additional shutdowns due to rising Covid-19 cases and the upcoming U.S. elections, kept the VIX Index elevated throughout the third quarter when it averaged 25.8, 8.5 points over its five-year average.

Election uncertainty continues to be seen in the VIX futures term structure. On August 31st the spread between the September and October VIX futures was more than double the previous 3 presidential elections.

In times of heightened uncertainty, education becomes a key driver to investor adoption. We ramped up our marketing and education efforts, accordingly. Third quarter initiatives included the launch of product-focused webinars, which we plan to expand in 2021; an ongoing revamp of our education website with enhanced learning tools to optimize investor understanding; and pilot testing of a new core derivatives education curriculum which we plan to launch in the first quarter of 2021. Additionally, our experienced team continues to work closely with customers so they may better understand how to leverage our diverse product set and trading resources to navigate changing market conditions.

We also continued in the third quarter to enhance our proprietary index product set, most notably with the August 9th launch of Mini VIX futures. The smaller VIX futures contract is designed to provide additional flexibility in volatility risk management and greater precision when allocating among smaller, managed accounts. Mini VIX futures were launched in response to market demand and the growing opportunity we saw among sophisticated retail market participants.

Since launch, we surpassed one million contracts traded and fully expect adoption to continue to grow as customers now have access to a smaller notional contract. We have rolled out ongoing marketing and education programs aimed at helping retail participants better understand how to leverage the benefits of Mini-VIX Futures trading.

We also see opportunity to expand retail adoption of XSP, our Mini SPX Index Options product, which has the benefit~~s~~ of cash settlement and potentially better tax treatment than SPY options. Beginning next week, we are moving XSP to our BZX exchange, which employs a maker-taker pricing model that incents market makers to provide tighter quotes, which in turn enhance market quality. XSP will also remain available for trading on our C1 hybrid exchange.

In other product news, we responded to the growing global demand for investment strategies focused on sustainability with the launch of options on the S&P 500 ESG Index in September. We're pleased to expand our exclusive suite of S&P DJI Index options and to provide market participants with an efficient means to incorporate ESG values into their investment portfolios.

We continue to optimize and diversify our business mix with recurring revenue through Cboe Information Solutions, our comprehensive suite of data solutions, analytics and indices. Our Information Solutions offering provides a value-added recurring revenue stream and supports transaction growth in our suite of proprietary products with tools that draw users to our markets and drive volume as they re-establish their trading positions.

The ongoing expansion of Cboe Information Solutions positioned us to effectively respond to the heightened demand we now see for historical data sales and subscriptions, contributing to the strong organic and inorganic growth of proprietary recurring non-transaction revenue in the third quarter.

Last quarter I provided a detailed update on the integration of the acquisitions made over the past year to further expand our Information Solutions offering, so I will just add here that those integrations remain on track and we expect to see greater customer demand as a result.

We also remain on track to launch Cboe European Derivatives in the first half of next year after making significant progress in its buildout during the third quarter. The platform is available for early testing with customers, and we have secured commitments from major sell-side firms, market makers and clearing firms to be participants from day one. We're pleased with the progress made thus far and I look forward to providing ongoing updates.

Turning now to our FX business, where we leverage the product innovation and technology expertise we deploy across all our markets to bring the benefits of an independent, transparent market structure to institutional foreign exchange trading. Among its benefits, our FX model provides greater control of the trading process, enabling better trade execution and lower transaction costs for our global customer base.

We're excited about the opportunities for organic growth and continue to effectively evolve this market. Over the last few months we significantly expanded and diversified our FX offering with the launch of Cboe FX Central, our new Central Limit Order Book, and Cboe Swiss, a new venue for trading Non-Deliverable Forwards (NDFs).

Alongside Cboe SEF, the launch of Cboe Swiss expands our NDF trading business to meet the diverse needs of a global client base. We see the continued electronification of the NDF market as a unique opportunity for further expansion given our strong technology platform, innovative data-driven approach to liquidity management and robust global footprint.

In closing I would like to thank the entire Cboe team for an extremely productive quarter. Their expertise and unwavering focus on the execution of our strategic growth initiatives enabled us to launch new products, close highly strategic deals, integrate new teams and services and expand our customer base.

Clearly, each new initiative aims to strengthen at least one pillar in Cboe's diversified product and services offering. But it is important to note that each is also designed to further leverage the entirety of our unique product ecosystem, which, powered by superior technology, enables us to synergistically shape and capture revenue from every phase of the trading cycle.

This past quarter we continued to leverage that unique value proposition and strengthen our leading industry operating efficiency by launching new products, attracting new users to our marketplace, enhancing recurring revenue streams and setting the stage to expand our products and services into new markets and geographies. Significantly, we accomplished all of this while continuing to generate positive financial results amidst unprecedented headwinds in institutional trading.

We continue to focus on that which we can affect. As a result, we are confident we are well positioned to benefit when trading winds change, as they inevitably do. Moreover, we are excited by the progress made and the new opportunities created in the third quarter to continue to further define markets, create opportunities for our customers and reward our shareholders.

With that, I thank you for your attention and will turn it back over to Brian.

Brian Schell, CFO

Thanks Ed, and good morning everyone. I hope everyone and their families are remaining safe and healthy. And I'd also like to thank my fellow Cboe associates for their continued hard work and dedication in advancing Cboe's growth initiatives.

Let me remind everyone that unless specifically noted, my comments relate to 3Q20 as compared to 3Q19 and are based on our non-GAAP adjusted results. While earnings declined year-over-year, we reported solid financial results for the quarter, again, highlighting the diversification of our revenue streams and the contributions from our investments, reinforcing our strategic initiatives:

- Our net revenue decreased 1%, with net transaction fees down 8% and non-transaction revenue up 1%;
- Adjusted operating expenses increased 13%, driven by our acquisitions;
- Adjusted EBITDA of $192 million was down 8%;
- And finally, our adjusted diluted earnings per share decreased 14% to $1.11.

We grew our quarterly recurring revenue stream of proprietary market data and access and capacity fees by 14% compared to third-quarter 2019, exceeding our prior guidance of mid-to-high single digits. This increase includes **organic growth** of 10%, and $5.0 million attributed to our acquisitions.

The organic growth reflects **11%** growth in access and capacity fees and **8%** in proprietary market data revenue, driven by increased demand for historical data sales and subscriptions, growth in new accounts and strong uptake on new data set offerings. The organic growth in proprietary market data and access and capacity fees continued to be driven by incremental subscriptions and units, accounting for 87% and 86% of the growth this quarter, respectively.

In our last call, we also noted that certain floor broker access and capacity fees were reinstated following the reopening our trading floor on June 15th. This resulted in higher access and capacity fees in 3Q20 compared to 2Q20, which were offset by lower RPC for index options.

Looking ahead to year-end, we now expect the underlying **organic growth** for the proprietary market data and access and capacity fee category to be mid-to-high single digits versus our prior guidance of mid-single digit; and we now expect the **reported growth** rate for these non-transaction fees to be low double-digits versus our previous guidance of mid-to-high single digits.

Now, a review of our segments.

In our options segment, the 1% or $2 million increase in net revenue primarily reflects strong trading volumes in our multi-listed options and growth in market data revenue, offset somewhat by lower trading volumes in our index options. Acquisitions contributed $4.5 million in options-related proprietary market data revenue. Additionally, industry market data revenue increased 13%, primarily driven by the growth in retail engagement. Also driven by strong retail engagement, the average daily volume (ADV) for multi-listed options rose 46%, while RPC was unchanged. The ADV for index options declined 29%, while RPC increased 12%, resulting in a 20% decline in index options net transaction fees. The index RPC increase was mainly due to a shift in volume mix, as well as an SPX fee increase implemented earlier this year. The decline in index RPC in 3Q versus 2Q, reflects the reversal of certain second-quarter fee changes after reopening the floor.

Turning to futures, the 39% or $15 million decrease in net revenue primarily reflects a 38% decline in ADV and 13% decrease in RPC, offset somewhat by lower royalty fees. The RPC variance was driven by two factors:

- First, the relaunch of mini VIX futures on August 9, which has a lower fee per contract (given it's at one-tenth the size of the standard VIX futures contract), and includes the impact of market maker incentives designed to promote liquidity and quality markets;
- Second, the growth of our iBoxx futures contracts, which has a significantly lower net capture also after incorporating market maker incentives.

Absent these, the RPC for the standard VIX futures contract grew nominally reflecting lower volumes.

In North American Equities, net revenue increased 1%, primarily due to higher net transaction fees offset by lower SIP market data revenue. U.S. equities volumes were strong again this quarter, with Cboe's matched volume up 25%, benefiting from the growth in retail trading activity, offset somewhat by a 15% decrease in net capture. The lower capture reflects pricing adjustments during the quarter aimed at increasing market share and attracting off-exchange order flow, while optimizing revenue across our P&L. We plan to monitor the response to these changes and modify accordingly, as we have done already with pricing changes implemented in October. Since August, our market share has increased nearly 100 basis points (as of October MTD results); additionally, we now have the second largest market share during continuous trading among the exchange groups during the month of October. We are confident that our efforts to drive best execution for retail customers, deploying unique order types such as retail priority and Cboe's midpoint discretionary order (MDO) will allow us to continue to build market share. Our share for the third quarter decreased year-over-year, primarily reflecting the growth in off-exchange trading, that reached new highs of 43% in 3Q20 versus 36% in 3Q19. The decrease in SIP market data revenue was driven by our lower market share and a $3 million decrease in audit recoveries.

Net revenue for European Equities increased $11 million or 53% on a U.S. dollar basis and 47% on a local currency basis, primarily reflecting over $10 million in revenue from EuroCCP this quarter. The decline in net transaction fees reflects lower market volumes and market share, offset somewhat by higher net capture. The higher capture resulted from continued strong periodic auction and LIS volume. The decline in market share was primarily a result of market profile shifts that impacted order flow to Cboe and higher share in systematic internalization activity. However, market share for the third quarter increased 190 basis points compared to the second quarter of 2020, reflecting positive response to a new pricing program and strong performance from our Periodic Auctions offering.

This quarter also included nearly $9 million in net clearing fees, reflecting transactions cleared and settled by EuroCCP. Turning to non-transaction revenue, the growth in access and capacity fees was primarily a result of incremental connections due to the opening of our Amsterdam office in October 2019 and the addition of EuroCCP. The increase in other revenue primarily reflects additional interest income earned on EuroCCP cash collateral accounts.

Net revenue for Global FX increased 1% this quarter driven by higher non-transaction revenue. Despite weaker industry volumes, our market share increased primarily as a result of positive response to our expanded offerings, including new and enhanced functionality on our platform. A decrease in net capture reflected a mix shift in volume by customer type. As Ed mentioned previously, we are quite pleased with the results of our FX business as we have continued to expand and diversify revenues streams, providing a more comprehensive suite of global FX trading services in spite of the challenging market conditions.

Turning to expenses, total adjusted operating expenses were about $109 million for the quarter, up 13% against last year's third quarter. Excluding the impact of acquisitions, adjusted operating expenses would have been down 2%. The key expense variances related to the acquisitions were in compensation and benefits and technology support services.

Expense Guidance:

Moving to guidance, we are lowering our 2020 adjusted operating expenses to a range of $415 to $420 million, down $21 million from the previous range of $436 to $444 million. We also tightened the range by $3 million, adjusting for the difference at the high-end of the range. This decrease reflects lower expenses related to compensation costs, including incentive compensation, professional fees, technology services and travel and promotional. Previously we noted that we expected to see a ramp up in expenses as the year progressed, however, we reassessed our expense priorities as part of our ongoing disciplined expense management. With this reduction, we now expect core expenses to decrease by approximately 7% year-over-year.

One point I made last quarter bears repeating. While a portion of the decline in the core expense growth is certainly attributable to the COVID-19 environment and its impact on expenses that I just noted – but our migration of the C1 platform in 2019 provides the underpinning, enabling the decrease in core expense growth.

2020 Tax Rate and Guidance

Turning to income taxes, our effective tax rate on adjusted earnings for the quarter was 30.8%, above our guidance range and last year's third quarter rate of 24.1%. The higher tax rate accounted for nearly 60% of the year-over-year decline in our adjusted diluted earnings per share. Absent the higher tax rate, the earnings per share decline would have been only 6%, which reflects the impact of lower earnings netted against the incremental benefit of reducing our share count by nearly 3% over the last 12 months.

The higher effective tax rate on adjusted earnings was primarily due to additional expense recognized upon the completion of our 2019 U.S. federal income tax return. Our 2020 full-year effective tax rate on adjusted earnings is now expected to be in a range of 27% to 29%, up from 26.5% to 28.5%, reflecting the higher third-quarter rate and a lower benefit from foreign operations in the fourth quarter.

Depreciation and Amortization / Capital Spending

We are decreasing our capital spending guidance for 2020 to $45 to $50 million from our previous guidance of $65 to $70 million, reflecting changes in timing for certain projects (including the build out of our new trading floor) and lower spending in others (including the build out our new global headquarters). Furthermore, we now expect depreciation and amortization to be $32 to $36 million for 2020, down from $34 to $38 million. Remember that our 2020 guidance reflects a reduction of $8 million in software development capitalization, which increases compensation expenses this year, but over time, decreases our depreciation and amortization expense. The updated guidance excludes amortization of intangibles of approximately $124 million, which was revised from our prior estimate of $120 million.

Turning to capital allocation, let me underscore, we remain focused on investing in the growth of our business to build upon our diversified business model while returning excess cash to shareholders through dividends and share repurchases. Our financial position remained strong and our cash flow generation capabilities enabled us to continue to return cash to shareholders. During the third quarter, we returned $46 million to shareholders through dividends and $42 million through share repurchases and we purchased an additional $35 million through the 29th of this month. We have availability of about $256 million remaining under our share repurchase program as of October 29, 2020.

At quarter end, debt increased by $70 million versus 2Q20, reflecting borrowings used towards funding our acquisition of MatchNow and third quarter tax payments. Our leverage ratio was 1.1 times at quarter-end, up slightly from 1.0 times at June 30, and we ended the quarter with adjusted cash of $213 million, reflecting in part, higher balances associated with additional regulatory and operating cash needs for EuroCCP. As previously announced, we plan to finance the pending acquisition of BIDS Trading with long-term debt, taking advantage of the historically low interest rates and thereby lowering our cost of capital.

In closing, Cboe's financial strength and cash flow generating capabilities have positioned us well. We intend to remain opportunistic as we execute on our growth initiatives and focus 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.

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operating a European clearinghouse; our ability to accommodate trading and clearing 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 or for whom we clear transactions; 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.

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