CBOE HOLDINGS, INC.
Third Quarter 2015 Earnings Call - Prepared Remarks
October 30, 2015

Debbie Koopman

Good morning and thank you for joining us for our third quarter 2015 earnings conference call.

On the call today, Ed Tilly, our CEO, will provide an update on our strategic initiatives for 2015. Then, Alan Dean, our Executive Vice President and CFO, will review our third quarter 2015 financial results. Following their comments, we will open the call to Q&A. Also joining us for Q&A are Ed Provost, President and COO, and John Deters, Chief Strategy Officer and Head of Corporate Initiatives.

In addition, I'd like to point out that this presentation will include the use of several slides. We will be showing the slides and providing commentary on each. A downloadable copy of the slide presentation is available on the investor relations portion of our website.

As a preliminary note, you should be aware that this presentation contains 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.

Now, I'd like to turn the call over to Ed Tilly.

Ed Tilly

Good morning and thank you for joining us today.

I am pleased to report that CBOE Holdings posted record financial results in the third quarter with new highs in operating revenues, operating margin and earnings per share. Tremendous industrywide volume in the third quarter was outpaced by record volume in our premium products, including S&P 500 Index (SPX) options, CBOE Volatility Index (VIX) futures and options, and Russell 2000 Index (RUT) options.

Record third quarter ADV in SPX options trading resulted in an increase of 39 percent sequentially and 36 percent year-over-year. SPX volume is up 8 percent year to date through October 28th.

On April 1, CBOE became the exclusive home of Russell 2000 Index options (RUT). We are pleased to note that ADV in RUT options reached a record high in the third quarter, increasing 23 percent over the previous quarter and 11 percent compared with 2014's third quarter, when RUT was still multiply-listed. We are confident we can continue to leverage our concentrated, non-fragmented pool of liquidity for RUT options to increase trading among institutional traders while expanding our customer base through joint marketing and educational efforts with our FTSE Russell partners.

Both VIX options and VIX futures posted their strongest quarter ever. ADV in VIX options increased 54 percent from the previous quarter and 45 percent from last year's third quarter. VIX futures ADV rose 43 percent sequentially and 32 percent compared with last year's third quarter. Year-to-date through October 28th, VIX options trading is down 11 percent and futures trading is up 2 percent.

Following spikes in volatility in the third quarter and a return to more historical VIX levels, we began to see somewhat lower levels of VIX in October. Regardless of market conditions, we remain focused on strategic initiatives that enable us to maintain profitability in periods of low volatility and to optimally benefit when volatility spikes and triggers increased trading.

We continue to execute our core growth initiatives through our unique ability to create, collaborate, and connect with the marketplace.

We launched VIX Weekly futures in July and VIX Weekly options earlier this month. VIX Weekly, combined with our standard monthly VIX options and futures, create a greatly expanded array of trading opportunities and tools to trade volatility. I am pleased to report on the strong debut for each product. Just weeks after launching, VIX Weekly options are averaging 25,000 contracts per day and hit a daily high of more than 68,000 contracts on October 22nd. VIX Weekly futures are averaging 300 contracts per day, with volume spikes of nearly 2,000 contracts per day. We are in the very early stages of developing this new dimension in VIX trading, but are beginning to see the same types of strategies and patterns that have characterized trading in standard VIX options, including more frequent rolling of certain strategies. We expect to see greater traction now that both futures and options are up and running and, in response to customer interest, we rolled out additional expirations this week and plan to add more expirations going forward.

On October 20th, we began the roll out of our new FTSE Russell products with the launch of options on the Russell 1000, the Russell 1000 Value, and the Russell 1000 Growth indexes. Passive assets linked to the three indexes total $360 billion. Our ability to offer options on Russell large caps, alongside our popular RUT contract, enables market participants to efficiently target and trade key segments of the U.S. equity market.

In all, the FTSE Russell Indexes licensed to CBOE represent a diverse group of domestic and global equities that offer international appeal. We look forward to the continued rollout of additional products, including the planned launch of options on the FTSE 100 and FTSE China 50 later this quarter.

CBOE continues to identify synergies and collaborate with strategic partners to extend our global reach. As recently announced, CBOE partnered with the London Stock Exchange Group (LSEG) and major dealer banks in the launch and development of CurveGlobal, an innovative interest rate trading venue.

CurveGlobal is expected to launch in the second quarter of 2016 with trading in futures based on major European interest rates. Additional products, including potential new products from CBOE, are expected to follow. CurveGlobal products will trade on the LSE Derivatives Market and will clear through LCH.Clearnet.

This is an exciting time to be in the global interest rate marketplace. Our strategic investment in CurveGlobal allows us to participate in that space through a trading venue that will be highly differentiated by the partnership of major dealer banks, new interest rate products, increased trading efficiencies and reduced transaction costs. Our CurveGlobal partnership also enables us to work collaboratively to develop new products and further grow our worldwide customer base.

We are pleased to be the U.S. anchor exchange for CurveGlobal and look forward to developing products suited to that venue and introducing the new platform to our U.S. customers.

As announced in September, we also entered into an agreement with Environmental Financial Products (EFP) to launch a new interbank lending exchange, called the American Financial Exchange (AFX). The new exchange is an electronic marketplace for small- and mid-sized banks to lend and borrow short-term funds. AFX also plans to provide a transaction-based interest-rate benchmark through weekly auctions to set a new rate for U.S. interbank lending, called Ameribor. CBOE looks forward to hosting, operating and helping to further develop this truly innovative marketplace.

Connecting our global customer base with CBOE premium products continues to be a top priority. Since the implementation of near 24-hour trading in VIX futures in June 2014, trading outside of regular U.S. trading hours in that product has grown to an average of nearly 9 percent of total trading. On days when we've seen major breaking news, that figure has grown to 20 percent.

This year, we launched an additional six-hour trading session in VIX and SPX options. The new VIX and SPX options session begins at 2:00 a.m. Chicago time, which aligns with the market open in London and the close in Asia. Trading in both products during European trading hours has steadily increased since the new session launched in March and, not surprisingly, increased dramatically when volatility spiked in July and August. This month, we added SPXPM options to our extended trading session and we will continue to add products where we see a need or opportunity.

We continue to connect with sophisticated end users and early adopters of CBOE products through our trademark CBOE Risk Management Conferences (RMC). In September, we hosted a record number of attendees at our fourth annual RMC Europe in Geneva. I am pleased to note that this year we are expanding RMC beyond the U.S. and Europe, with the first RMC Asia, which will run November 30th and December 1st in Hong Kong.

Our first RMC Asia will coincide with this quarter's planned launch of options on the FTSE China 50 as well as the launch of the CBOE Options Institute at the Singapore Exchange. We are thrilled to extend our global reach in the growing Asian marketplace.

In closing, I will note that our record third quarter volume and financial results were made possible by the talent and tenacity shown by the entire CBOE team in the face of sustained market headwinds in the first six months of 2015. Our team's ability to stay the strategic course, even amidst challenging conditions, placed CBOE in a position to benefit optimally when the tide inevitably turned, as it did in July and August.

It is very gratifying, of course, to reward our shareholders by posting record volume and financial results, but the tremendous quarter we just enjoyed also confirms and invigorates the confidence of our entire team in CBOE's long-term strategy to further define and expand the options and volatility space. I want to thank our shareholders, our customers, and our entire team for their continued support and shared belief in our vision for CBOE.

With that I will turn it over to Alan Dean.

Alan Dean

Thanks Ed and good morning everyone.

Let me start with an overview of our results for the quarter. As Ed highlighted, CBOE achieved record results in the third quarter, hitting new highs on a number of financial measures fueled by record trading volume in our proprietary products. Operating revenue came in at $187.0 million, 26 percent above last year's third quarter. Operating income was $101.1 million, representing an operating margin of 54.1 percent, up 370 basis points compared with 50.4 percent in the third quarter of 2014. Adjusted net income allocated to common stockholders was $63.0 million, up 31 percent versus the third quarter of 2014, resulting in adjusted diluted earnings per share of $0.76, an increase of 33 percent compared with $0.57 per share for the same period last year.

Before I continue, let me point out that our GAAP results reported for the third quarter of 2015 include certain unusual items that impact the comparison of our operating performance. These items are detailed in our non-GAAP information provided in the press release and in the appendix of our slide deck.

Now, let's review our results in more detail, starting with operating revenue. As shown on this chart, the increase in operating revenue primarily resulted from higher transaction fees along with an increase in exchange services and other fees, offset somewhat by decreases in access fees and other revenue.

Transaction fees increased $40.5 million, or 39 percent, compared with the third quarter of 2014 resulting from a 31 percent increase in the average revenue per contract (or RPC) and a 6 percent increase in trading volume versus last year's third quarter.

Total trading volume in our options products rose 5 percent, while the volume in our highest-margin futures contracts increased 32 percent over last year's third quarter. Furthermore, looking at options trading volume by product category, our higher-RPC index options significantly outperformed the lowest-RPC, multiply-listed options. Average daily volume in equity options decreased by 20 percent, options on exchange-traded products were generally unchanged and index options grew by 41 percent year-over-year and 44 percent compared with the second quarter.

Our blended RPC, including options and futures, increased to 43.1 cents from 32.9 cents in last year's third quarter. The increase in RPC primarily reflects a favorable shift in the mix of trading volume to proprietary products, as well as RPC growth across each product category.

Looking at the mix of trading volume by product category, our highest margin index options and futures contracts accounted for 44.6% of our trading in the third quarter, up from 33.8% in the same period last year.

The RPC in our options business increased to 36.8 cents compared with 27.5 cents in the third quarter of 2014, largely due to the favorable volume mix. In addition, we saw RPC increases of 39 percent for equity options, 25 percent for options on exchange-traded products and 4 percent for index options, primarily resulting from fee adjustments made this year and lower volume discounts and incentives.

Revenue per contract at CFE, our futures exchange, increased 1 percent to nearly $1.65 from $1.62 in last year's third quarter, reflecting the impact of fee changes implemented in January, offset somewhat by higher volume-related rebates.

As a result of the shift in the volume mix and RPC increase, transaction fees generated from our proprietary products represented a higher proportion of our total transaction fees year-over-year and sequentially. In the third quarter, index options and futures contracts accounted for 84.0 percent of our transaction fees, up from 81.3 percent in the third quarter of 2014 and 82.4 percent in the second quarter of this year.

Looking at some of the other factors influencing operating revenue, exchange services and other fees increased by $1.5 million. This increase was largely due to higher fees for systems services and revenue contributed from Livevol technology services, which became part of CBOE Holdings on August 7th.

Access fees declined by $1.6 million, reflecting a decrease in trading permits. Other revenue fell by $0.9 million, primarily due to a decrease in revenue generated from regulatory service agreements, which ceased as of December 31, 2014.

Turning to expenses, this next slide details total operating expenses of $85.9 million for the quarter, an increase of $12.1 million, or 16 percent, compared with last year's third quarter. Operating expenses for the quarter reflect higher costs for royalty fees, professional fees and outside services, depreciation and amortization and compensation and benefits.

Core operating expenses were $51.1 million, an increase of $4.8 million or 10 percent, compared with the third quarter of 2014.

This increase primarily reflects higher costs of $4.4 million in professional fees and outside services and $0.9 million in compensation and benefits. As we have noted in prior quarters, the increase in professional fees and outside services is primarily attributed to our outsourcing of certain regulatory services to FINRA, which occurred in December of 2014.

The increase in compensation and benefits largely reflects higher incentive-based compensation, which was driven by the company's improved financial performance. This increase was offset somewhat by a decrease in salaries, due to the decline in staffing resulting from the outsourcing of certain regulatory services.

As we mentioned on our last earnings call, given the sustained improvement in trading volume, we are unwinding certain cost reductions we put in place earlier this year.

As a result, we are updating our guidance for core expenses. We now expect core expenses for the year to be in the range of $194 million to $196 million, up from previous guidance of $190 million to $194 million, but still below the range we provided back in February of $195 million to $199 million. This change largely reflects higher performance-driven incentive compensation, which is directly tied to our financial results.

Looking at volume based-expenses, royalty fees increased by $5.6 million, or 35 percent, reflecting the strong growth in licensed products traded during the quarter.

Looking at the royalty rate per licensed contract traded, it came in at $0.146 this quarter, below the $0.163 we saw in the second quarter, resulting from a shift in the mix of products traded. Looking forward, depending on the mix of products traded, I would expect the rate per licensed contract to be somewhere within this range.

Our GAAP effective tax rate for the quarter was 33.4 percent, which includes the benefit of the release of uncertain tax positions. Excluding a non-GAAP adjustment of $4.3 million, the effective tax rate for the current quarter was 37.7 percent.

Year to date, our adjusted effective tax rate of 38.5 percent is in line with our guidance range for the full-year 2015 of 38.5 percent to 39.5 percent.

Turning to the balance sheet, we finished the quarter with cash and cash equivalents of $122 million, compared to $90 million at the end of June and $148 million at the end of 2014.

CBOE is a strong cash producing business. Through September, we generated net cash flows from operating activities of nearly $194 million versus $184 million in the same period last year, largely driven by the increase in net income.

Through September of this year, we have used more than $54 million to pay dividends and nearly $101 million to repurchase our stock.

Capital expenditures through September were $27 million. Looking out to the end of the year, we are reaffirming our prior guidance of $37 to $40 million. This capital spending includes the development of our new trading platform, CBOE Vector. I am pleased to say that phase one of this project, which is the build out of new systems for CFE, is on track. We expect the new CFE system to be up and running in the third quarter of 2016, with CBOE and C2 to follow.

At September 30, 2015, we had approximately $92.2 million remaining under our existing share repurchase authorizations. Our capital allocation philosophy remains unchanged; first and foremost we will continue to invest in the growth of our business. We remain committed to returning excess cash to shareholders through sustainable dividends and share repurchases. We believe that one of the best investments available today is our own company, so we plan to continue to opportunistically repurchase our stock.

In summary, our third quarter results demonstrated the strength of our business model, powered by positive operating leverage that produced strong cash flows and record-setting operating margins. We continue to see solid growth opportunities ahead and look forward to continuing to deliver long-term value for all of our stakeholders.

our ability to maintain our growth effectively; our dependence on third party service providers; and the ability of our compliance and risk management methods to effectively monitor and manage our risks.

More detailed information about factors that may affect our performance may be found in our filings with the SEC, including in our Annual Report on Form 10-K for the year ended December 31, 2014 and other filings made from time to time with the SEC.