CBOE HOLDINGS, INC.
Second Quarter 2015 Earnings Call - Prepared Remarks
July 31, 2015

Debbie Koopman

Good morning and thank you for joining us for our second 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 second quarter 2015 financial results. Following their comments, we will open the call to Q&A. Also joining us for Q&A is our President and COO, Ed Provost.

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 solid earnings in the second quarter, despite the low-volume, low-volatility trading environment that persisted throughout the industry for most of the quarter. I am also pleased to note that as volatility began to spike and trading activity picked up toward the quarter's end and into July, CBOE was well-positioned to benefit, most notably in our premium index products.

Let's take a look at a few of the volume bright spots. Second quarter ADV in S&P 500 Index (SPX) options trading, while down sequentially, rose 5 percent from 2014's second quarter and is up 6 percent year to date through July 29th.

As expected, we saw a significant ADV increase in Russell 2000 Index (RUT) options, which began trading exclusively at CBOE in April. We have seen volume increase each month since CBOE became the home of RUT options and, in July, RUT posted its strongest month of the year. We are confident we will further grow our RUT marketplace going forward. As the exclusive home for RUT options, CBOE not only provides the product with a concentrated pool of liquidity, we are also able to leverage our position as the go-to-place for all things related to index options to connect with new and existing RUT customers worldwide. RUT options are now prominently featured across a range of CBOE educational channels, including the Options Institute, CBOE's Risk Management Conferences (RMC), and the Options Hub, our highly trafficked social media platform.

CBOE also saw stronger VIX trading. VIX options ADV rose 22 percent from the previous quarter. The trend within the quarter was also positive, with month-over-month increases that continued into July, which is on track for another monthly sequential increase of 15 percent.

VIX futures ADV rose 11 percent over the second quarter 2014 and is up 12 percent in July compared to June. ADV in both VIX options and futures for July is on track to be at its highest monthly levels since last October.

Recent volatility spikes notwithstanding, we remain in a low-vol regime, with the VIX Index still hovering well below historical levels. Still, we remain guardedly optimistic about VIX trading in the second half of the year, given the return of large traders to the market, a maturing U.S. bull market, and impending U.S. interest rate hikes.

Regardless of volume trends and the ebb and flow of VIX, our strategy is straightforward. We will continue to execute our core growth initiatives to increase index and volatility trading at CBOE - domestically and abroad - through our unique ability to create, collaborate, and connect with the marketplace.

Overseas investors continue to embrace SPX and VIX options for efficient exposure to the U.S. equity market and global volatility, and we continue to make it more convenient for them to access those products.

Last year, we implemented near 24-hour trading in VIX futures. VIX futures volume during non-U.S. trading hours held steady at a little over 8 percent in the second quarter. As the Greek debt crisis escalated in the second week of July, however, the overnight session accounted for as much as 13 percent of VIX volume, which averaged nearly 300,000 contracts per day for the week.

In March 2015, we implemented an additional six-hour trading session in VIX and SPX options beginning at 2:00 a.m. Chicago time to align with the open of trading in London and the close in Asia. As expected, volume in extended trading hours in both SPX and VIX options has been a gradual, steady build with the exception of July, when volume in VIX options, like VIX futures, rose dramatically in the face of heightened global volatility.

Product innovation is a cornerstone of our growth strategy. We were thrilled last week to launch Weekly VIX futures and look forward to rolling out the options on October 8th. VIX Weeklys are a natural extension and complement to standard VIX futures and options, offering investors more opportunities to trade VIX. VIX Weeklys also respond to customers who tell us they are looking for volatility exposures that more precisely track our benchmark VIX Index. The closer VIX futures and options are to expiration, the closer they track the VIX Index. By “filling the gaps” between monthly expirations, Weeklys offer investors short-term protection, as well as the ability to fine-tune the timing of their trades.

We received significant customer demand to list VIX Weeklys futures and early feedback from both the buy- and sell-side has been positive. We are encouraged that we have seen some volume from day one. We expect VIX Weeklys futures volume to continue to gradually build as we roll out additional expirations and launch VIX Weeklys options.

In other product development news, on August 3rd, we will be unveiling ten new CBOE option strategy benchmarks that highlight the long-term utility of options as risk management and yield enhancing investment tools. Two of the benchmarks will use popular SPX Weekly options to create new versions of our flagship CBOE S&P500 BuyWrite Index (BXM) and PutWrite (PUT) Indexes. The other indexes highlight completely new systematic hedging and risk-managed option selling strategies featuring SPX and VIX options.

Our new options-based strategies are aimed at providing fund managers, investment advisors, institutional investors and others with tangible measures of how options - particularly CBOE’s proprietary options - can be used creatively to improve risk-adjusted returns within an investment portfolio.

Education and product development go hand in hand at CBOE, and CBOE’s Options Institute continues to grow and pave the way for greater understanding of our evolving products and marketplace. We were particularly excited therefore to announce plans for the first extension of the Options Institute in collaboration with the Singapore Exchange (SGX), which is expected to launch in the fourth quarter of this year.

CBOE's world-renowned Options Institute conducts nearly 400 educational events per year, including classroom training at our state-of-the-art facility, webcasts and off-site seminars. A wide range of offerings and course levels allows us to connect with customers across a range of touchpoints as their educational and trading needs evolve and grow.

The CBOE Options Institute at SGX will leverage CBOE's options expertise and the Options Institute brand name with SGX's position as a gateway to the region's financial markets as we look to respond to the tremendous interest we see for our products in Asia.

The CBOE-SGX collaboration enables us to quickly and efficiently ramp up to meet the growing demand for options education in the region. Instructors at SGX will be trained by veteran instructors from the Options Institute at CBOE. The Institute's trademarked content highlights CBOE products and will be translated into Mandarin by SGX.

The Options Institute at SGX marks the second CBOE educational initiative planned for Asia in 2015. As previously announced, we are expanding CBOE's Risk Management Conference (RMC) beyond the U.S. and Europe with the first RMC in Asia later this year. RMC, which attracts sophisticated and influential market participants who tend to be early adopters of new CBOE products and services, will make its Asia debut in Hong Kong, November 30th to December 1st.

I'll wrap up here by commending the entire CBOE team for maintaining a disciplined and consistent approach to executing our strategic growth initiatives throughout the second quarter and beyond, regardless of macro trading conditions. A companywide commitment to our strategy for long-term growth positioned CBOE to benefit optimally when market conditions changed, as they did most notably in June and July. We are pleased to begin the third quarter with that positive momentum and we are very enthusiastic about the opportunities that lie ahead to further increase index and volatility trading at CBOE.

With that, I will turn it over to Alan.

Alan Dean

Thanks Ed and good morning everyone.

Let me start with an overview of our results for the quarter. CBOE turned in a solid performance for the second quarter, achieving top-line and bottom-line growth both year-over-year and sequentially. We were particularly pleased to see stronger trading volume throughout the quarter and into July in our VIX Index options, despite the continuation of lackluster trading in multiply-listed options industrywide. Operating revenue came in at $148.7 million, 3 percent above last year's second quarter. Operating income was $73.4 million, representing an operating margin of 49.3 percent, up 90 basis points compared with 48.4 percent in the second quarter of 2014. Net income allocated to common stockholders was $44.6 million, up 5 percent versus the second quarter of 2014, resulting in diluted earnings per share of $0.54, an increase of 8 percent compared with $0.50 per share for the same period last year.

We had no non-GAAP adjustments for the second quarter of 2015 or 2014, so the financial results discussed for the quarter are on a GAAP basis.

Now, I'll review our results in more detail, starting with operating revenue. As shown on this chart, the increase in operating revenue primarily reflects increases in transaction fees and other revenue, offset somewhat by decreases in access fees and regulatory fees.

Transaction fees increased $3.7 million, or 4 percent, compared with the second quarter of 2014 resulting from a 14 percent increase in the average revenue per contract (or RPC), partially offset by a 9 percent decrease in trading volume versus last year's second quarter. While total trading volume in our options products was down 10 percent, the volume in our highest margin futures contracts increased 10 percent over last year's second quarter. Furthermore, looking at options trading volume by product category, our higher margin index options outperformed the lowest-margin, multiply-listed options. Trading volume in equity options decreased by 15 percent, options on exchange-traded products fell by 12 percent and index options declined by 2 percent year-over-year, but increased 7 percent compared with the first quarter.

Offsetting the volume decline, our blended RPC, including options and futures, increased to 36.8 cents from 32.2 cents in last year's second quarter. The increase in RPC primarily reflects the net impact of a higher RPC generated across each product category as well as a shift in the mix of trading volume towards our higher-margin, proprietary products.

The RPC in our options business increased to 30.8 cents compared with 27.5 cents in the second quarter of 2014, reflecting RPC increases of 18 percent for equity options, 5 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 7 percent to nearly $1.76 from $1.64 in last year's second quarter, as a result of fee changes implemented in January and a change in the mix of market participants.

With respect to the shift in the volume mix, our highest margin index options and futures contracts accounted for 37.2% of total trading volume in the second quarter, up from 33.9% in the same period last year.

As a result of the shift in the volume mix and higher RPC, transaction fees generated from our proprietary products represented a higher percentage of our total transaction fees year-over-year and sequentially. In the second quarter, index options and futures contracts accounted for 82.4 percent of our transaction fees, up from 80.9 percent in the second quarter of 2014 and 81.3 percent in the first quarter of this year, largely driven by the higher contribution from our futures business.

Looking at some of the other factors influencing operating revenue, other revenue increased by $3.8 million, primarily due to higher regulatory fines assessed to trading permit holders for disciplinary actions. This revenue will be used to offset regulatory expenses.

In addition, access fees declined by $1.4 million, reflecting a decrease in trading permits.

Regulatory fees decreased $1.1 million, which is primarily attributed to lower rates for our options regulatory fee compared to the second quarter of 2014 and the elimination of regulatory fees related to CBSX, our stock exchange which ceased trading in 2014.

Turning to expenses, this next slide details total operating expenses of $75.3 million for the quarter, an increase of $1.1 million, or 2 percent, compared with last year's second quarter. Operating expenses for the quarter reflect higher costs for professional fees and outside services, royalty fees and depreciation and amortization, offset somewhat by lower costs for compensation and benefits.

Core operating expenses were $46.7 million, a decrease of $1.8 million or 4 percent, compared with the second quarter of 2014.

This decline primarily reflects a decrease of $6.2 million in compensation and benefits, partially offset by an increase of $4.7 million in professional fees and outside services. The decline in compensation and benefits largely reflects lower expenses related to salaries, stock-based compensation and the provision for incentive compensation. The increase in professional fees and outside services, as well as the decrease in salaries, is primarily attributed to our outsourcing of certain regulatory services to FINRA, which occurred in December of 2014.

As we told you on our last earnings call, during the second quarter we took steps to cut or delay certain expenses and capital projects in response to sluggish trading volumes. At the same time, we noted that we would look to unwind certain cost reductions following a sustained improvement in volumes. Given the improvement we have seen in our VIX index options and futures volume, along with the continued strong volume in SPX options, we plan to gradually reverse some of the cost cuts in the coming months.

We always viewed the cost cutting measures as a short-term solution to a short-term problem and are pleased that volume has returned to a level that we are comfortable dialing up certain expenses and projects in a disciplined manner.

Taking this into account, we still expect our core expenses for the year to be in the range of $190 million to $194 million; however, I expect to be at the high end of this range for the full year.

Looking at volume based-expenses, royalty fees increased by $2.1 million, or 14 percent, primarily due to a shift in the mix of licensed products traded, which resulted in a higher average royalty rate per licensed contract for the quarter.

Previously, we told you that we expected the royalty rate per licensed contract to be $0.15 starting in the second quarter. The rate per contract came in higher, at $0.163, reflecting the shift in mix I referenced earlier, which we saw in the first quarter as well. Looking forward, I would expect the rate per licensed contract to stay at this level, barring any significant shift in the mix of products traded.

Turning to the balance sheet, we finished the quarter with cash and cash equivalents of $90 million, compared to $138 million at the end of March and $148 million at the end of December. The decrease in cash compared to March primarily reflects tax payments made during the quarter.

Our business continues to generate a significant amount of cash. Through June, we generated net cash flows from operating activities of nearly $106 million versus $121 million in the same period last year.

Capital expenditures through the first half of the year were just under $18 million. I look for capital spending to pick up somewhat in the back half of the year, so we are reaffirming our guidance for capital expenditures of $37 to $40 million for the full year, which includes the development of our new trading platform, CBOE Vector.

Through the first half of this year, we have used more than $35 million to pay dividends and nearly $82 million to repurchase our stock.

At June 30, 2015, we had approximately $111.0 million of availability remaining under our existing share repurchase authorizations, which includes an additional $100 million authorized by our Board back in May. Our Board has authorized $500 million to use for share buybacks since the inception of our program in 2011.

Further underscoring our commitment to returning capital to shareholders, we were pleased to announce that the Board increased our quarterly dividend rate by 10 percent to $0.23 per share from $0.21 per share, effective with the third quarter dividend payment. This increase is our fifth consecutive since we instituted a dividend payment in September of 2010. Since that time, our compounded average growth rate for our quarterly dividend has been 18 percent.

So let me conclude by saying, we are very optimistic about the growth opportunities we see going forward. As we begin the second half of the year, we have good momentum in our business and remain in a strong financial position. We will continue to make the necessary investments to position CBOE for long-term growth while prudently managing our use of cash in the near-term.

This presentation may contain forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are those statements that reflect our expectations, assumptions or projections about the future and involve a number of risks and uncertainties. These statements are only predictions based on our current expectations and projections about future events. There are important factors that could cause actual results to differ materially from that expressed or implied by the forward-looking statements, including: the loss of our right to exclusively list certain index options and futures products; increasing price competition in our industry; compliance with legal and regulatory obligations and obligations under agreements with regulatory agencies; decreases in the amount of trading volumes or a shift in the mix of products traded on our exchanges; our ability to operate our business, monitor and maintain our systems or program them so that they operate correctly, including in response to increases in trading volume and order transaction traffic; the accuracy of our estimates and expectations; legislative or regulatory changes; increasing competition by foreign and domestic entities; our index providers ability 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 maintain access fee revenues; our ability to protect our systems and communication networks from security risks, including cyber-attacks; economic, political and market conditions; our ability to attract and retain skilled management and other personnel; 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.