CBOE HOLDINGS, INC.
Fourth Quarter 2015 Earnings Call - Prepared Remarks
Wednesday, February 3, 2016

Debbie Koopman, VP Investor Relations

Good morning and thank you for joining us for our fourth quarter conference call. On the call today, Ed Tilly, our CEO, will discuss the quarter and our strategic initiatives for 2016. Then, Alan Dean, our Executive Vice President and CFO, will detail our fourth quarter 2015 financial results and provide guidance on certain financial metrics for 2016. Following their comments, we will open the call to Q&A. Also joining us for Q&A will be our President and COO, Ed Provost and our Chief Strategy Officer and Head of Corporate Initiatives, John Deters.

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, CEO

Good morning and thank you for joining us today.

I am pleased to report another year of record financial results at CBOE Holdings. Despite low volatility and lower trading volumes industrywide in 2015, CBOE Holdings posted record volume in our index trading complex led by new all-time highs in SPX options and VIX futures. We also significantly expanded our premium products and global customer reach, while forming new alliances to complement our core strengths and diversify our product offering.

The ability to further develop trading in our premium products while optimizing our operational efficiency drove new annual highs in revenue and earnings, making 2015 our company's fifth consecutive year of record financial results, enabling us to reward our shareholders through increased dividend payments and share repurchases.

CBOE continues to lead the industry in all options trading by a significant margin. In the very competitive and fluid multiply-listed options arena, CBOE implemented pricing changes that resulted in lower market share, but higher revenue per contract in 2015. At the close of the year CBOE ranked second among the 13 options exchanges with a market share of 15.7 percent. We further adjusted pricing in 2016 and, for the month of January, CBOE ranked first among all options exchanges with a market share of 16.8 percent in multiply-listed classes.

Our mission for 2016 and beyond is to be the leader in providing innovative products that facilitate and enhance trading in a global marketplace. Our strategy is straightforward: continue to develop unique products, expand our customer base, form alliances that leverage and complement our core business, and continue to define and lead the options and volatility space globally.

While product innovation is central to our value proposition, we are equally committed to further developing our current products. CBOE's S&P 500 Index (SPX) options remain the most actively traded U.S. index option and, after 32 years, continue to thrive and grow.

Average daily volume (ADV) in our SPX options in 2015 rose 6 percent for a third consecutive year of record volume. Gains were driven largely by strong Weeklys trading, a product that has attracted retail investors to our largely institutional SPX marketplace. We've seen a strong start in 2016 with January SPX ADV increasing 19 percent compared with the prior year and 33 percent compared with December.

As recently announced, we plan later this month to introduce SPX Weeklys with Wednesday Expirations. "Wednesday Weeklys," in addition to end-of-week expirations, will increase opportunities to trade SPX and enable investors to better target specific expirations. Wednesday Weeklys will also align with the Wednesday expirations of VIX Weeklys futures and options, providing greater trading flexibility for the increasing number of customers who use both VIX and SPX products.

Turning now to VIX futures and options. Historically low levels of market volatility dominated much of 2015, punctuated by significant volatility spikes in the third quarter. While VIX options ADV was down 9 percent from last year's record pace, VIX futures posted a sixth consecutive record volume year with a gain of 2 percent over 2014. Elevated volatility, and less certainty in the marketplace going into 2016, have driven dramatic increases in VIX trading. In January, VIX options and futures trading was up 34 and 19 percent, respectively, over January 2015.

Expanding our VIX offering and marketplace is a major opportunity and priority in 2016. We continue to leverage our VIX methodology to create new products, as evidenced by the debut of VIX Weeklys futures in July 2015, followed by VIX Weeklys options in October. VIX Weeklys options averaged 35,000 contracts per day in 2015. We expect continued growth in 2016, given our ongoing business development efforts and the inherent utility of Weeklys trading.

In other VIX news, we plan next month to begin overnight dissemination of the "spot" VIX Index. As you know, VIX measures the real-time implied volatility of S&P 500 options. Our implementation of extended trading hours in SPX -- from 2 a.m. to 8:15 a.m. Central Time -- enables us to calculate and disseminate VIX in that time period, thus allowing market participants to view volatility during the overnight session through the same lens used in regular U.S. trading hours. Overnight dissemination of VIX will yield valuable real-time volatility information when news breaks overnight and will allow overseas investors to reference VIX during their regular trading hours, further cementing the role of VIX as the world's gauge for market volatility.

Leveraging partnerships with index providers is key to product innovation at CBOE. We became the sole U.S. provider of major FTSE Russell index products in 2015, beginning with Russell 2000 Index (RUT) options in April. I am pleased to report that January was a strong month in RUT options with ADV of 106,000 contracts. We plan in 2016 to further leverage our concentrated index option liquidity pool while expanding our customer base through joint marketing and educational efforts with our FTSE Russell partners.

Last quarter we launched options on the Russell 1000 and Russell 1000 Growth and Value Indexes and we plan to launch options on the FTSE 100 and FTSE China 50 indexes next month. The global exposure afforded by our exclusive U.S. offering of FTSE Russell products, as well as MSCI products, brings a growing international dimension to our index options franchise.

CBOE continues to identify synergies and form alliances that leverage our strengths and enable us to efficiently diversify our product and business lines across new regions and asset classes.

In the fourth quarter, we announced our partnership with the London Stock Exchange Group (LSEG) and major dealer banks in the launch and development of the CurveGlobal interest rate platform, which will trade on the LSE Derivatives Market and clear through LCH.Clearnet. We anticipate a second-quarter launch of CurveGlobal with trading in futures based on major European interest rates. Additional products, including potential new products from CBOE, are expected to follow.

Also in the fourth quarter, we teamed with Environmental Financial Products (EFP) for the December 11th launch of the American Financial Exchange (AFX), an electronic marketplace for small and mid-sized banks to lend and borrow short-term funds. CBOE now hosts, operates and is helping to develop AFX, which saw a total value of $326 million of unsecured overnight loans transacted in January, its first full month of trading. We anticipate increased trading in 2016 with the expected participation of additional banks and with new product offerings. AFX plans to launch a 30-day, unsecured loan product, as well as other new products, including a new transaction-based interest-rate benchmark for U.S. interbank lending called Ameribor.

CBOE continues to leverage the marketing and educational efficiencies afforded by a comprehensive suite of CBOE index options and volatility products. In support of an increasingly global product line, we are actively engaging a worldwide customer base through an ambitious educational agenda and by facilitating access to our products and markets through trading technology.

Last quarter, in collaboration with the Singapore Exchange (SGX), we launched the CBOE Options Institute at SGX, the first extension of our educational facility. We also expanded our Risk Management Conferences (RMC) with the first CBOE RMC Asia, which successfully debuted this past quarter in Hong Kong. And, I'm pleased to announce today that this year CBOE plans to establish its first international business development outpost with the opening of an office in London.

In what we see as a groundbreaking opportunity to expand options and volatility trading, CBOE last week made a majority equity investment in Vest Financial, an investment advisor that provides options-based services through packaged products and develops technology solutions for options-based investments.

The Vest managed account platform is accessible through financial advisors and designed to provide investors with access to the same investment tools and protections available to institutions and high net worth individuals.

Our investment in Vest allows for enhanced integration of CBOE's proprietary products, strategy indexes and options expertise within Vest's platform, which substantially reduces the complexity of options trading while providing investors with targeted protection, enhanced returns, and a level of predictability unattainable with most other investments. Vest also plans to launch Unit Investment Trusts (UITs), Mutual Funds and Exchange Traded Products (ETPs).

I'll close here by thanking the entire CBOE team. As a result of their ongoing efforts, we significantly expanded our product line and increased index trading throughout 2015, despite challenging conditions. We are obviously pleased with the uptick in trading we saw in January, but regardless of the ebb and flow of trading volume, our team remains focused on developing new products, expanding our customer base, and forming alliances that complement our core strengths. Maintaining that focus enables CBOE to continue to define and lead the options and volatility space globally, an approach that continues to serve our customers and shareholders alike. We are energized by the early year-to-date momentum and by the significant opportunities in 2016 to write the next great chapter in CBOE's ongoing growth story. With that, I will turn it over to Alan Dean.

Alan Dean, CFO

Thank you Ed and good morning. Thanks to everyone for joining us to discuss our fourth quarter results.

This morning, I will walk you through our financial results for the quarter and then provide guidance on certain financial metrics for 2016.

While CBOE Holdings produced strong results for the quarter, we do have a difficult comparison against last year's record-setting fourth quarter.

A brief summary of our results for the quarter are shown on this slide. Adjusted operating revenue was $154.0 million, down 8 percent compared with last year's fourth quarter. Adjusted operating income was $73.9 million, representing an adjusted operating margin of 48.0 percent, down 540 basis points versus the fourth quarter of 2014. Adjusted net income allocated to common stockholders was $48.9 million, a 9 percent decrease compared with 2014's fourth quarter, while adjusted diluted earnings per share decreased 8 percent to $0.59.

Before I continue, let me point out that our GAAP results reported for the fourth 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.

Turning to the details of the quarter. Adjusted operating revenue decreased by $12.5 million, primarily due to a decline in transaction fees resulting from lower trading volume versus the fourth quarter of 2014. Let me also note that adjusted operating revenue excludes $2.0 million, included in other revenue that represents the recognition of revenue to adjust for incorrect coding of transactions by an exchange participant related to prior periods.

Transaction fees were down $11.9 million or 10 percent from last year's fourth quarter, due to a 25 percent decline in trading volume, partly offset by a 20 percent increase in the average revenue per contract (or RPC).

Our blended RPC, including options and futures, was 40.8 cents compared with 34.0 cents in the fourth quarter of 2014. This increase resulted from a shift in the mix of trading volume towards our highest RPC products - index options and VIX futures, as well as an increase in RPC across each product category.

The RPC in our options business increased to 34.9 cents compared with 28.4 cents in last year's fourth quarter. The RPC on equity options and exchange-traded products increased by 43 percent and 36 percent, respectively, while the RPC on index options rose 4 percent. The RPC increases were primarily due to fee changes made earlier in the year and a decrease in volume discounts and incentives.

On the futures side, CFE's revenue per contract increased 4 percent to $1.69 from $1.62 in the fourth quarter of 2014, primarily resulting from a more favorable mix of trades by account type, as well as fee changes.

As this slide depicts, the contribution from our highest-margin index options and futures contracts accounted for 40.9 percent of total volume in the fourth quarter versus 35.3 percent in 2014's fourth quarter.

Converting the volume into transaction fees, you see that index options and futures contracts accounted for 83.1 percent of transaction fees, down slightly from 83.7 percent in the fourth quarter of 2014. For the full year, proprietary products accounted for 82.9 percent of transaction fees, up from 81.8 percent in 2014.

Looking at other variables influencing operating revenue, access fees declined by $1.3 million or 9 percent compared with last year's fourth quarter, primarily due to a decline in the number of market maker permits. For the full-year 2016, we expect to see a modest decline in access fees, which is consistent with my previous comments on this line item.

On the plus side, exchange services and other fees increased by $2.4 million. This increase mainly resulted from higher fees for systems services and revenue contributed from Livevol technology services, which we acquired on August 7th.

For 2016, we expect exchange services and other fees to increase to around $47 million, which tracks the fourth quarter run rate and is primarily due to the addition of Livevol.

Now turning to expenses. This slide details total adjusted operating expense of $80.1 million for the fourth quarter of 2015, up $2.4 million or 3 percent, compared with $77.7 million in the fourth quarter of 2014. Adjusted operating expense excludes $1.9 million of severance expense in the fourth quarter of 2014. There were no non-GAAP adjustments to expenses for the fourth quarter of 2015.

This next slide details core operating expense of $49.7 million for the fourth quarter, an increase of $3.2 million or 7 percent, compared with the fourth quarter of 2014. The increase was primarily driven by a $4.4 million increase in professional fees and outside services, offset somewhat by a $0.7 million decrease in compensation and benefits.

As was the case in previous quarters of 2015, the increase in professional fees and outside services was primarily attributed to our outsourcing of certain regulatory services to FINRA, which occurred in December of 2014.

The decrease in compensation and benefits primarily reflects lower salaries due to the staffing reduction that occurred in 2014 in conjunction with our regulatory services outsourcing.

Volume-based expenses, which include royalty fees and order routing, were $18.1 million for the quarter, a decrease of $2.1 million or 10 percent, primarily reflecting a $1.5 million decline in royalty fees and a $0.6 million decline in order routing. The decrease in royalty fees was mainly due to lower trading volume in licensed products, which includes index options and VIX futures.

Before I move on to taxes, I want to comment on other income and expenses, which increased by $3.5 million on an adjusted basis in the fourth quarter, primarily due to the dividend declared by the Options Clearing Corporation (OCC) in December.

Our adjusted effective tax rate was 36.7 percent for the fourth quarter of 2015, compared with 39.4 percent in 2014's fourth quarter. The change in the adjusted effective tax rate primarily resulted from the preferential tax treatment on the OCC dividend income we recognized in the fourth quarter of 2015. Our adjusted effective tax rate for the full-year 2015 was 38.0 percent compared to 38.2 percent for 2014.

We expect our effective tax rate for 2016 to be in the range of 38.5 percent and 39.5 percent. Additionally, if OCC declares a dividend in the fourth quarter of 2016 comparable to 2015's fourth quarter, we would expect our effective tax rate to be lower in the fourth quarter compared with the first three quarters of the year, due to the tax treatment relating to the dividend income.

Let's turn now to a few highlights relating to our balance sheet and capital allocation. In 2015, we generated more than $245 million in cash from operating activities. For the year, our free cash flow was $206 million and we distributed $208 million to shareholders through dividends and share repurchases, while also continuing to fund strategic investments and our growth initiatives that Ed highlighted.

For the year, we returned more than $73 million through dividends and more than $135 million through share repurchases. We repurchased over 2 million shares through our share repurchase program, at an average price of $61.63, reducing shares outstanding by nearly 3 percent in 2015. Since our share repurchase program was implemented in August of 2011, we have reduced our shares outstanding by 8 percent.

At December 31, we had cash and cash equivalents of $102 million and $57 million remaining on our share repurchase authorizations.

Our capital management framework remains unchanged. We are committed to funding the growth of our business, then to return capital to our shareholders through sustainable quarterly dividends and share repurchases. We are confident in our ongoing ability to enhance shareholder value.

Moving to our guidance for 2016, core expenses for the full-year 2015 came in at about $195 million and in line with our guidance. You might recall, we started 2015 at a range of $195 to $199 million and pulled back on expenses in response to lackluster volume we experienced earlier in the year.

For 2016, we expect core expenses to be in a range of $211 to $215 million, representing an increase of 8 to 10 percent versus 2015 and an increase of 6 to 8 percent compared to the high end of our original 2015 guidance. The increase in 2016 primarily reflects higher expenses for outside services, largely related to our regulatory services agreement, and higher expenses related to the addition of Livevol. However, both of these items also contribute revenue that is expected to offset the incremental expenses. Excluding the expense increases relating to these particular items, our core expenses would be up by 4 to 6 percent compared to 2015, which is in line with our baseline objective. We expect regulatory revenue to increase by about $3 million, reflecting the higher expenses we plan to incur to carry out our obligations as a regulator, and we expect exchange services and other fees to increase by about $5 million, primarily due to Livevol.

We also plan to increase spending to support our business development and marketing efforts.

Moving on, capital spending in 2016 is expected to be between $47 to $49 million, up somewhat compared with the $39 million we spent in 2015 as we continue the development of our new trading platform, CBOE Vector. As we stated previously, this project is being done in three phases. Phase one is the build out of new systems for CFE, which is on track to be up and running in the third quarter of 2016, with CBOE and C2 to follow.

Depreciation and amortization expense is expected to be between $46 to $48 million, compared with $46 million in 2015. The year-over-year projected change reflects additions to capital and lower depreciation expense relating to certain regulatory software that will be fully-depreciated at June 30, 2016, which corresponds with a planned transfer to FINRA systems. Following this systems transition to FINRA, certain expenses are expected to shift from depreciation and amortization to outside services, accounting for part of the increase in outside services I mentioned in discussing core expenses.

We are off to a strong start in 2016 and are excited about the opportunities we see ahead as we continue to focus on the strategic initiatives that Ed outlined, while also effectively managing expenses and deploying capital.

Thank you for your interest in CBOE. I will now turn it back to Debbie so we can take your questions.