CBOE HOLDINGS, INC.
First Quarter 2015 Earnings Call - Prepared Remarks
May 1, 2015

Debbie Koopman

Good morning and thank you for joining us for our first 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 first 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.

Despite the first quarter's challenging volume conditions, we made significant progress in expanding our suite of premium index products. We secured the rights to trade numerous Russell and FTSE Index products at CBOE, began exclusive trading in Russell 2000 Index options, and launched options on two well-known MSCI benchmarks. We also expanded our global customer reach with extended trading hours for SPX and VIX™ options. I will discuss more about these developments after a brief update on volume.

Our first quarter results reflect the impact of lower trading volume experienced at CBOE Holdings and industrywide, as well as a difficult comparison to last year's record first-quarter results. Overall, CBOE Holdings' volume fell 15 percent in the first quarter, compared with the same period in 2014. The decline generally mirrored trading levels in futures and options industrywide, with the exception of a sharper decrease in VIX options.

At the time of our last call, we saw the flattened term structure as the primary factor weighing on VIX options trading, while at the same time SPX option volume was setting new records. Term structure was certainly a factor at that point, but there was a larger change occurring with regard to investor sentiment.

Many risks that investors were concerned about: falling oil prices, deflation, global economic slowdown, political unrest overseas, seemed to be resolving, and more local risks, such as the Fed's plan to raise interest rates, kept getting pushed farther into the background. Traders came to regard sharp drops in the market as buying opportunities rather than signaling a new bear market. What makes volatility trading - VIX options, VIX futures, ETN volatility contracts and OTC VIX options - a compelling risk management tool is that it tends to work especially well as a hedge against sharp market declines, often referred to as "tail events." In the absence of real concerns about a sharp, sustained market pullback, it makes sense that traders would find fewer uses for volatility products and use other index options - such as SPX options - for directional exposure to stock prices. I should note that SPX volume was up one percent in an otherwise down quarter.

Nothing we learned about the current lull in trading has caused us to alter our expectations or strategic initiatives related to the ongoing, long-term growth in VIX options trading. Buy-side customers and sell-side brokers alike generally expect volume and open interest to pick up as conditions change. We see the decline in VIX options volume as generally cyclical rather than structural. We have seen cycles like this before, they are part of trading, and while we don't like to see them, we expect them.

In the meantime, an ongoing disciplined approach to cost-management enables us to weather the inevitable volume troughs, while continuing to lay the foundation for future growth. As a result, CBOE's forward progress is undeterred, despite current volume challenges.

We are particularly enthusiastic about the recent progress made to advance CBOE's ongoing index growth story. I'll look at that here through the lens of CBOE's unique position and our innate ability to collaborate, connect, and create.

Thus far in 2015, CBOE has leveraged new partnerships with index providers to significantly expand and diversify our premium index product line across new assets and markets. The products resulting from these agreements create new trading opportunities for our customers and pave the way for new volatility indexes, as well.

Our December 2014 licensing agreement with MSCI made CBOE the sole U.S. exchange to list options on several MSCI indexes. Our recent launch of options on MSCI's EFA and Emerging Markets indexes brings an added global dimension to our index options franchise and introduces new trading opportunities across our unique product set. Last year, nearly 100 million options traded industrywide on the popular EFA and EEM ETFs. Our ability now to also offer cash-settled, European-style options on these indexes will especially appeal to institutional customers. We created additional trading opportunities by aligning the options settlement times to match the futures trading on the indexes.

Last quarter we also entered into an exclusive licensing agreement with the London Stock Exchange Group, making CBOE the exclusive provider for listed cash-settled options on more than two dozen FTSE and Russell Indexes; including the flagship Russell 2000 and FTSE 100.

As you know, CBOE previously traded Russell 2000 (RUT) options on a semi-exclusive basis. In 2014, RUT options were CBOE's third most actively traded index option, trailing only SPX and VIX options. Over 12 million RUT contracts traded at CBOE and C2 and more than 22 million contracts traded industrywide. Under the new agreement, CBOE became the sole provider of RUT options on April 1st and we now look forward to launching FTSE 100 index options, as well as other Russell and FTSE products, later this year.

The addition of MSCI, FTSE and Russell options to a product suite anchored by SPX options and VIX futures and options enables customers to hedge and trade global volatility, the global stock market, the broad U.S. stock market, the U.S. small cap market, European and Asian international equities, and the world's emerging markets at CBOE.

These products are often used in tandem, which creates additional trading opportunities. Each index enables us to create related volatility options and futures using our VIX methodology, thereby growing our VIX product line and offering still more trading possibilities. We believe these trading synergies will foster a further concentration of index traders and liquidity at CBOE, while enabling us to leverage significant cross-marketing efficiencies.

We continue to extend CBOE's customer reach, domestically and abroad, through customer engagement, investor education and broadened access to our marketplace. Education goes hand-in-hand with product innovation at CBOE. Each new product is supported by new educational content, allowing us to form new connections with an expanding customer base.

Our exclusive agreements with S&P, LSE Group and MSCI, in part, were predicated on CBOE's educational expertise and ability to efficiently connect with index customers globally across a range of channels, including The Options Institute, CBOE TV, CBOE.com, CBOE's social media platform and CBOE's Risk Management Conferences (RMC).

I should note here that this year we are expanding our RMC program beyond the U.S. and Europe with the first RMC in Asia. RMC showcases our premium index products and attracts sophisticated and influential market participants who tend to be early adopters of new CBOE products and services.

I am pleased to say we made it easier for customers to connect with CBOE by further increasing access to our premium products. In early March we extended trading hours in VIX and SPX options with an additional session that runs from 2 a.m. to 8:15 a.m. Chicago time. The new session enables overseas customers to access VIX and SPX options during local trading hours and satisfies the stateside demand for additional trading time.

In other VIX news, I am pleased to announce that, pending regulatory approval, we plan to introduce Weekly VIX options and futures at CBOE and CFE. We plan to launch the futures this July, with the options to follow. Our new VIX Weeklys products will complement VIX futures and options, the same way that SPX Weeklys complement our standard SPX product. VIX Weeklys will 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 VIX. By "filling the gaps" between monthly expirations, we are providing investors with 40 new opportunities to establish short-term VIX positions, and fine tune the timing of their hedging and trading activities. For the first time, investors will be able to trade expiring VIX and SPX contracts each week, which we believe will create even more trading opportunities.

CBOE's ability to collaborate, create and connect with the marketplace has created a unique culture of innovation, not only in product development, but also in trading technology. Systems development is deeply embedded in our value proposition. While every exchange aims for faster, more efficient trading technology, CBOE's systems have always been uniquely developed in-house to power innovation.

I am pleased to announce today that development of the next generation of trading technology is currently underway at CBOE. The new platform, called CBOE Vector^{SM}, is designed to provide streamlined access to the most comprehensive array of options and volatility products in the world and to the deep liquid markets in which they trade.

We are leveraging our in-house trading and technology expertise in building a customized, state-of-the-art platform that responds to the trading needs of our customers and that best supports CBOE's unique product set.

We have supplemented our experienced systems team with top developers in our space to ensure that every aspect of CBOE Vector is on the cutting edge and that we have the bench strength needed to drive the optimal performance of our current system, CBOE Command, throughout the completion of the new platform.

Incorporating input from customers, we are developing an advanced architecture that delivers best-in-class functionality, low latency, ease of use, and trading efficiency. The new platform will be engineered to provide greatly increased transaction speeds while handling constantly increasing message traffic and industry demand for additional functionality, such as risk controls.

The build out for CBOE Vector calls first for the implementation of new systems for CFE, which we project will be up and running in the second half of 2016, with CBOE and C2 to follow.

Ed Provost can provide more color on our new platform in Q&A, but I want to stress here that CBOE Vector is integral to our ongoing index story. We view it as both a state-of-the art trading platform and engine for growth, designed for maximum flexibility and scalability, enabling us to quickly respond to a rapidly changing marketplace and to efficiently roll out new products and trading opportunities.

I will close here with this graphic representation of the opportunities created by our progress already in 2015.

We expanded our proprietary product offering to cover new asset classes and regions around the world, increased trading hours to improve global access and extended our global customer reach. Importantly, we also enriched CBOE's unique eco-system for the development and support of new tradable index products going forward. More than any one product, CBOE's unique value proposition -- to our customers, shareholders and index-provider partners -- lies in our ability to optimize the utility of new and existing index products through unrivaled options and volatility trading opportunities, educational expertise, an efficient network of customer outreach channels, deep liquid markets and customized trading technology. This comprehensive approach to a singular area of focus, has fostered a multitude of new opportunities for CBOE in 2015 and beyond. We look forward to providing updates in the months and quarters ahead.

With that, I will turn it over to Alan.

Alan Dean

Thanks Ed and good morning everyone.

I will start this morning with a review of our results for the quarter and then I will wrap up with some comments on our focus for managing expenses and capital allocation going forward.

CBOE's first quarter results reflect the downturn we saw in trading volume both year-over-year and sequentially. Operating revenue came in at $142.8 million, 10 percent below last year's first quarter. Adjusted operating income was $69.5 million, representing an adjusted operating margin of 48.7 percent, a decline of 490 basis points compared against our all-time high of 53.6 percent in the first quarter of 2014. Adjusted net income allocated to common stockholders was $42.3 million, a decrease of 15 percent versus the first quarter of 2014, resulting in adjusted diluted earnings per share of $0.50, a 14 percent decline compared with $0.58 per share for the same period last year.

Before I continue, let me point out that our GAAP results reported for the first quarter of 2015 and 2014 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. All the numbers I will be referencing are on a non-GAAP basis.

Now, let's review our results in more detail, starting with operating revenue. As shown on this chart, the decrease in operating revenue was primarily driven by lower transaction fees.

Transaction fees decreased $14.1 million, or 12 percent, compared with the first quarter of 2014 reflecting a 15 percent decrease in trading volume, offset somewhat by a 3 percent increase in the average revenue per contract (or RPC) versus last year's first quarter. Trading volume declined year-over-year in each product category - equity options were down 17 percent, options on exchange-traded products fell 9 percent, index options decreased 20 percent and futures contracts were down 8 percent.

Our blended RPC, including options and futures, increased to 34.0 cents from 32.9 cents in last year's first quarter. The increase in RPC primarily reflects the net impact of a higher RPC generated on index options and futures contracts, offset somewhat by a shift in the mix of trading volume towards lower-margin, multiply-listed options.

The RPC in our options business increased to 28.4 cents compared with 28.1 cents in the first quarter of 2014, reflecting a 6 percent increase in the RPC for index options and a 1 percent increase for options on exchange-traded products, primarily resulting from fee adjustments made this year and lower volume discounts and incentives. The RPC for equity options decreased by 5 percent year-over-year and increased by 13 percent compared with the fourth quarter of 2014. The sequential increase in the RPC for equity options is due in part to fee changes implemented for 2015. While we also saw a decline in market share due to these fee changes, it was share that was low to negative margin for CBOE.

Revenue per contract at CFE, our futures exchange, increased 5 percent to $1.70 from $1.62 in last year's first quarter, as a result of fee changes and lower volume rebates.

With respect to the shift in volume mix, multiply-listed options represented 66.7 percent of total contracts traded in the first quarter, up from 65.3 percent in the first quarter of 2014.

Despite the shift in the mix of volume, transaction fees generated from our proprietary products represented a higher percentage of our total transaction fees year-over-year. In the first quarter, index options and futures contracts accounted for 81.3 percent of our transaction fees, up from 81.0 percent in the first quarter of 2014, driven by the higher contribution from futures contracts.

Looking at some of the other factors influencing operating revenue, access fees declined by $1.5 million, reflecting a decrease in trading permits. Regulatory fees were also down by $1.5 million, which is attributed to lower trading volume industrywide as well as the elimination of regulatory fees related to CBSX, our stock exchange which ceased trading in 2014, and a lower rate for our options regulatory fee compared to the first quarter of 2014.

On the plus side, other revenue increased by $0.9 million, primarily due to higher fines assessed to trading permit holders for disciplinary actions, which can only be used to offset regulatory expenses. In addition, market data fees increased by $0.9 million, primarily as a result of higher revenue from CBOE's market data services, reflecting an increase in subscribers and rate adjustments.

Turning to expenses, this next slide details total adjusted operating expenses of $73.3 million for the quarter, unchanged compared with last year's first quarter. Operating expenses for the quarter reflect the net impact of lower costs for compensation and benefits and royalty fees, offset by higher costs for professional fees and outside services, depreciation and amortization and technology support services. There were no adjustments to operating expenses in the first quarter of 2015.

Core operating expenses of $47.9 million also were relatively flat year-over-year, with an increase of $0.2 million, or 1 percent, compared with the first quarter of 2014.

The increase in core operating expenses primarily reflects increases of $4.6 million in professional fees and outside services, $0.6 million in technology support services and $0.5 million in travel and promotional expenses, offset by a decrease of $5.4 million in compensation and benefits. 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 the company's outsourcing of certain regulatory services to FINRA, which occurred in December of 2014.

In response to current trading volumes, we are taking steps to cut or delay certain expenses and capital projects, as we have done during previous volume downturns. Based on our cost reduction initiatives and year-to-date results, we are lowering our guidance for core expenses to a range of $190 million to $194 million from our previous guidance of $195 million to $199 million. While disciplined cost management is a continuous focus at CBOE, when volumes decline, we push even harder to realign expenses against revenue.

With that said, we will remain diligent in our efforts and will look to reduce expenses further if volume continues to languish. Conversely, I would look to wind down some of the cost reductions when I see a sustained improvement in volumes.

Looking at volume based-expenses, royalty fees decreased by $1.7 million, or 11.0 percent, reflecting the decline in trading volume for licensed products, which include index options and VIX futures. On our last earnings call we told you that we expected the rate per contract for royalty fees to be $0.14 for the first quarter and $0.15 in the following quarters. The rate per contract came in higher, at $0.146, due to a shift in the volume mix among licensed products. Looking out to subsequent quarters, I would expect a continued divergence in the rate per licensed contract if the volume mix stays the same as it was in the first quarter. However, if the volume mix is more aligned with what we saw in 2014, I would expect the rate to be closer to our guidance.

Turning to the balance sheet, we finished the quarter with cash and cash equivalents of $138 million, compared to $148 million at the end of December. The decrease in cash compared to year end primarily reflects cash used for share repurchases, dividend payments and funding our share of the contribution to the OCC capital plan.

Our business continues to generate a significant amount of cash. Through March, we generated net cash flows from operating activities of over $78 million versus $88 million in the same period last year. This decrease primarily reflects lower net income.

In the first quarter of this year we used nearly $18 million to pay dividends and another $34 million to repurchase our stock. At March 31, we had approximately $58 million available under our share repurchase authorization. We will continue to be opportunistic in our share repurchases and look for sustainable growth in our annual dividend payments.

Capital expenditures through March were $8 million. I look for capital spending to pick up 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 takes into account the development of our new trading platform.

Against that backdrop, it is important to point out that our guidance for both capital expenditures and core expenses now reflects the addition of a major new project, which was not included in our prior guidance.

We are very disciplined in how we use our cash, particularly given the current headwinds we are facing. However, our priorities regarding the use of cash have not changed. Our first priority is to reinvest in our business to drive future growth, as evidenced by our plans to invest in a new trading platform. After that, we expect to return our free cash flow over the long term to investors through a combination of dividends and share repurchases.

While the near-term environment is challenging, we have encountered business downturns in the past and historically have always emerged even stronger. Our entire team is confident that our focus on managing expenses while investing in future growth will create long-term value for our market participants and shareholders.

With that, I will turn the call back over to Debbie for Q&A.

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.