CBOE HOLDINGS, INC.
Third Quarter 2013 Earnings Call - Prepared Remarks
November 1, 2013

Debbie Koopman

Good morning and thank you for joining us for our third quarter 2013 earnings conference call. On the call today, Ed Tilly, our CEO, will provide an update on our strategic initiatives for 2013. Then, Alan Dean, our Executive Vice President and CFO, will review our third quarter 2013 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. I'm happy to report another strong quarter at CBOE Holdings, driven by increased trading volume overall and in our higher-margin proprietary products, in particular. Our team continued to execute on CBOE's company-wide goal to maximize market share in multiply-listed options, while developing and promoting the higher-margin, proprietary products that distinguish CBOE in the global marketplace. Our business continued to grow as a result, posting a 7 percent increase in operating revenue and a 9 percent increase in adjusted diluted earnings per share for the quarter. Alan will take you through the financial results in more detail, after I run through the highlights for the quarter.

First, a look at options volume and market share. Total options ADV at CBOE Holdings grew 5 percent from the third quarter last year and declined 7 percent from the second quarter 2013. Year-over-year, volume increased 20 percent in index options and 18 percent in ETNs and ETFs, offset by a 10 percent decline in equity options.

CBOE continued to increase its industry leading market share. Excluding dividend trades, CBOE accounted for 28.0 percent of all options trading in September, up from 26.9 percent in June. We garnered 20.9 percent of multiply-listed options, up from 19.7 percent in June.

Throughout 2013, we've noted the ongoing growth of VIX futures and options trading, despite prolonged periods of low market volatility. More recently, as VIX reacted to October's government shutdown and the threat of default, we saw the effects of spikes in volatility on VIX trading. Investors increasingly turned to VIX futures and options to buffer the changing political and economic winds and, on October 8th, VIX options volume reached a new single-day high of 1.78 million contracts, surpassing the previous record of 1.40 million contracts set on April 15th this year.

While volume spikes like those seen in October provide a glimpse into the "great beyond" for ongoing growth in VIX futures and options trading, it is important to note that October's gains followed yet another quarter of remarkable growth in VIX trading absent significant marketplace volatility. Third quarter ADV in VIX options and futures grew 21 and 48 percent, respectively, over the third quarter 2012. Record volume days may grab the headlines, but the continued growth of these products amidst historically low volatility is -- to us -- an even more compelling story that validates the tremendous utility of these products and the headway we have made in promoting them. Turning now to an update on those efforts . . .

This past Monday we successfully implemented the first phase of our extended trading hours initiative in VIX futures, which provides for an additional 45-minute trading session following the regular close of VIX futures trading at 3:15, central time.

We look forward to implementing phase two, which adds another five hours to the trading day, this Monday, November 4th. This phase will allow European-based customers to access VIX futures during their local trading hours. Trading will begin at 2:00 a.m. CT, which aligns with the 8:00 a.m. open of the London markets. We are pleased to provide expanded trading hours, not only to our European customers, but to what has become a truly global base of current and potential VIX users.

In October we hosted our second Annual CBOE Risk Management Conference (RMC) in Europe, where I was once again reminded that VIX is truly the *world's* gauge for market volatility.

RMC Europe drew 150 sophisticated market practitioners keenly interested in SPX and VIX trading. We were delighted to make two volatility-related product announcements at the conference, beginning with our plans to launch futures and options on the Russell 2000 Volatility Index, or RVX.

The Russell 2000® is the premier measure of the performance of small-cap U.S. stocks. Russell 2000 options (RUT) is our third most-actively traded index option. RVX is calculated by applying our VIX methodology to RUT options. We are thrilled to provide customers with the ability to trade the volatility of the Russell 2000 Index. We are working closely with our equally enthusiastic partners at Russell Investments to bring these products to market. Our plans call for RVX futures to launch on November 18th and RVX options to launch on December 2nd.

Our second major product announcement at RMC was the creation of the CBOE Short-Term Volatility Index (ticker symbol: VXST℠). The new Short-term VIX is calculated using our proprietary VIX methodology and was designed to complement VIX. Whereas VIX has a 30-day horizon, the Short-term VIX looks out just nine days, making it particularly responsive to changes in short-term volatility. Together, the two indexes provide an unrivaled picture of expected market volatility.

We expect to launch VXST Weeklys options and futures in the first quarter of 2014, pending regulatory approval. Customer response to Short-term VIX Weeklys has been positive and enthusiastic. We anticipate investors will embrace the new products as a means to pinpoint and hedge the volatility associated with market events, such as earnings and Fed announcements, and to generally fine tune the timing of their volatility trades.

We are thrilled to introduce a product that combines the most compelling aspects of VIX futures and options and SPX Weeklys. To a great extent, the dramatic growth story of VIX futures and options has overshadowed the tremendous increase in SPX Weeklys trading. CBOE created the Weeklys concept in 2005 with the launch of SPX Weeklys, now one of our fastest growing products.

A recent study by the Tabb Group, "U.S. Options Trading 2013," notes that firms are leveraging Weeklys as liquidity builds and product availability expands. Tabb predicts Weeklys volume will reach 25 percent of total industry volume by year's end.

At CBOE, SPX Weeklys YTD volume through September is up 127 percent over last year's record pace. Moreover, SPX Weeklys trading has created a new SPX customer base, which includes individual retail investors and what we refer to as active semi-professionals. Both groups favor the trading precision afforded by the product's shorter-time horizons and lower premiums. Semi-pros, in particular, appreciate that SPX Weeklys -- like SPY options -- have point-and-click access, but represent 10 times the notional value of SPY Weeklys.

Global interest in SPX and the opportunity to grow SPX options trading among overseas investors mirrors that of VIX futures and options. Overseas investors gravitate to SPX products, much as they do to VIX products, for their efficiency in hedging global economic risk. Simply put, VIX has become a proxy for global market volatility, while SPX enables investors to access the broad U.S. market with a single transaction.

Given the numerous synergies of our two marquee products, our overseas VIX marketing and educational efforts enable us to cost effectively extend our SPX marketing reach, as well. Frankly, we couldn't be more enthusiastic about the opportunity to increase trading in both product lines.

On that note, I will wrap up by saying that our entire team is excited by the opportunities to continue to build volume and liquidity in our VIX and SPX products and to create new streams of liquidity through new products, such as futures and options on our new Short-term Volatility Index.

As we close in on the end of 2014, we remain focused on the strategic initiatives we laid out at the beginning of the year: new product development, maximizing our revenues in multiply-listed products, extending our customer reach, and providing the highest standards in market regulation and compliance.

With that, I thank you for your attention and now turn it over to Alan Dean.

Alan Dean

Thanks Ed and good morning everyone.

This morning I will review the key drivers of our third quarter financial results and comment on our outlook for the remainder of 2013.

Let me start with a quick overview of the key stats for the quarter. We delivered another strong quarter with operating revenue of $136.7 million, up 7 percent compared with last year's third quarter. Operating income was $68.4 million, representing an operating margin of 50.0 percent - a 260 basis point improvement over the same quarter last year. Adjusted net income allocated to common stockholders was $41.0 million, up 9 percent compared with the third quarter of

2012, resulting in diluted earnings per share of $0.47, a solid improvement versus adjusted diluted earnings per share of $0.43 for the same period last year.

Before I continue, let me point out that our GAAP results reported for the third quarter of 2012 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. There were no adjustments to our operating results in this year's third quarter but in last year's third quarter we did have some non-GAAP adjustments relating to the tax provision, which I will discuss later.

Turning to the details of the quarter, as shown on this chart, the growth in operating revenue was driven by increases in transaction fees, regulatory fees and exchange services and other fees, offset somewhat by a decrease in other revenue.

Transaction fees increased $6.4 million, or 7 percent, from the third quarter of last year due to an 8 percent increase in trading volume, offset slightly by a 1 percent decrease in the average revenue per contract (or RPC) versus last year's third quarter. The growth in trading volume was primarily driven by the continuing growth trajectory of our proprietary products, with total trading volume in index options up 22 percent and futures contracts up 52 percent. Exchange-traded products also contributed to the volume gain, increasing 19 percent, while equities declined 9 percent.

Our blended RPC, including options and futures, was 31.5 cents, down slightly from 31.7 cents in last year's third quarter. The decline was primarily due to an increase in volume-based incentives for certain multiply-listed options traded at CBOE under our volume incentive program, or VIP.

As a result, the RPC in our options business declined to 27.3 cents compared with 28.7 cents in last year's third quarter. The revenue per contract on equity options and exchange-traded products declined by 35 percent and 31 percent, respectively. On the plus side, the lower RPC in these products was significantly offset by the ongoing shift in product mix toward our highest-margin index options and futures contracts.

In the third quarter, CFE's revenue per contract was $1.56, a slight decrease compared with last year's third quarter, reflecting discounts provided on certain trades.

Multiply-listed options continue to represent a declining percentage of our trading volume and transaction fee revenue, primarily due to the tremendous growth we are witnessing in our proprietary products.

As depicted on this slide, in the third quarter of this year, index options accounted for 29.9 percent of total contracts traded, up from 26.5 percent in last year's third quarter. Futures contracts accounted for 3.2 percent of total volume compared with 2.3 percent in last year's third quarter.

The shift in the mix of trading volume towards our highest-margin products fueled much of the growth in transaction fees for the third quarter of 2013. Index options and futures contracts accounted for 79 percent of our transaction fees for the quarter, up from 69 percent in the third quarter of 2012. We continue to see the strongest growth potential coming from our proprietary products and look forward to the introduction of our new volatility products Ed discussed, as well as continued growth from our flagship products.

The $3.2 million increase in regulatory fees was primarily due to increases in our options regulatory fees. As we pointed out in our last earnings call, since the revenue derived from these fees is only available to cover expenses we incur to carry out our obligations as a regulator, we make adjustments as needed to keep that revenue and related expenses in balance. To that end, effective September 1, we reduced the options regulatory fee for CBOE and suspended the options regulatory fee for C2. This change, in addition to lower industry-wide customer volume, resulted in a $1.5 million decline in regulatory revenue for the third quarter compared with the second quarter. This variance was split about 50/50 between the options regulatory fee changes and lower industry-wide customer volume traded by our permit holders, which was down about 13 percent versus the second quarter. Assuming similar trading volume in the fourth quarter as the third quarter, we would expect regulatory fees to decline by about $1.6 million in the fourth quarter compared against the third quarter.

The decrease in other revenue was primarily due to lower fines assessed to trading permit holders resulting from disciplinary actions. In last year's third quarter there was one particularly large fine, which accounts for this variance.

Moving down the income statement to expenses, this next slide details total operating expense of $68.3 million for the quarter, up only $0.8 million or 1 percent, versus last year's third quarter. This increase primarily reflects higher royalty fees, offset somewhat by lower expenses for outside services and travel and promotional costs.

Core operating expense of $44.8 million decreased $1.3 million, or 3 percent, compared with the third quarter of 2012. The key variance accounting for this decline was lower costs for outside services, resulting from a decline in legal expenses.

Overall, year-to-date through September, core operating expense annualized is tracking in line with our guidance range and where we expect to be for the full year.

Looking at volume based-expenses, royalty fees increased by $2.5 million, or 22 percent. This increase is directly related to the growth in trading volume in licensed products, as well as certain royalty fee adjustments.

Our GAAP effective tax rate for the quarter was 39.1 percent versus 24.4 percent in last year's third quarter. This variance was due to the recognition of significant discrete items in 2012, with no comparable benefits recognized in 2013. 2012's effective tax rate included the benefit of discrete items relating to prior years totaling $7.7 million or $0.09 per share, as well as the impact of the recognition of other discrete items.

As you can see from this slide and the press release exhibits, we have broken out the adjustments to GAAP results. Based on our year-to-date results, we now expect our effective tax rate for the full-year 2013 to be in a range of 39.0 to 39.5 percent.

Taking a look at the balance sheet, we finished the quarter with cash and cash equivalents of $226.4 million, compared to $207.8 million at the end of June.

Our business continues to generate strong cash flows from operations. Year-to-date we have generated approximately $172 million in cash from operations, paid nearly $43 million in dividends, used about $20 million for capital expenditures and another $20 million to purchase stock.

After investing in the growth of our business, we have continued to return cash to our shareholders through dividend payments and share repurchases. We repurchased over 306,000 shares in the third quarter at a total cost of $14 million and an average price of $45.63. At quarter end, $89.3 million remained available in our current share repurchase authorizations.

We will continue to be disciplined in our repurchase activity, which will vary based upon stock price and other factors.

Lastly, I would like to provide an update on our guidance for the remainder of the year. Incorporating our results through September, we now expect capital spending to be in the range of $33 million to $36 million, primarily reflecting lower spending than anticipated on certain projects. Due to the change in our outlook for capital spending, we are lowering depreciation and amortization to a range of $34 million to $36 million.

In summary, we had another solid quarter and we are off to a very strong start in the fourth quarter with record trading volume in our proprietary products for October. We are well positioned for continued growth and increased operating leverage going forward with positive business momentum, operating and expense discipline and a healthy balance sheet.

With that, I will turn the call back over to Debbie.

At this point, we would be happy to take questions. We ask that you please limit your questions to one per person to allow time to get to everyone. Feel free to get back in the queue and if time permits we'll take a second question.