CME Group Q216 Earnings Call Prepared Remarks

July 28, 2016

John Peschier

Thank you for joining us this morning. Gill and John will spend a few minutes discussing the results and then we will open up the call for your questions. Terry, Bryan, Derek and Sean are on the call as well, and will participate in the Q&A session.

Before they begin, I'll read the safe harbor language. Statements made on this call, and in the slides on our Web site, that are not historical facts are forward-looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or implied in any forward-looking statements. More detailed information about factors that may affect our performance may be found in our filings with the SEC, which are available on our Web site.

With that, I would like to turn the call over to Gill.

Phupinder Gill

- Thank you Mr. Peschier and thank you all for joining us. It is another solid quarter for us. Average daily volume in Q2 rose by 13 percent, the same growth rate as our record first quarter. We had double-digit growth again from each of our buy side client groups, including asset managers, hedge funds, proprietary trading firms, corporates and retail. Despite the recent slowdown in volatility post-Brexit as measured by the VIX, we are tracking up 10 percent compared with last July.

- We were pleased to set an open interest record in the second quarter of over 116 million contracts and we are near peaks in our large open interest holder data in several product areas.

- This morning, I will start with our secular drivers and then I will shift to a few product highlights.

- We have consistently expanded our global participation in spite of the challenging macro environment. We saw robust electronic trading activity outside of the US, with Asia up 21 percent vs. Q2 last year, Latin America rose 16 percent, and Europe rose 12 percent. Following the Brexit announcement, we had significant activity from outside of the US, with 5.3 million contracts traded from Europe and 1.9 million contracts traded from Asia the day after. In Q2, the electronic volume from outside of the US was 24 percent, in July that has jumped to 27 percent, and the day after Brexit – 29 percent of the activity was outside of the US.

- In Europe, volumes in 5 of our product areas grew by more than 20 percent, with the strongest growth in energy and equities, with year-to-date ADV up 38 percent and 35 percent respectively.

- In Asia, Q2 ADV in energy rose by more than 140 percent and metals volumes jumped more than 80 percent. Latin America growth was also led by energy.

- In addition to the country of origin information that we share with you, we also track electronic volume throughout the 24-hour trading day. In Q2, volume during Asian hours grew by almost 40 percent from 260,000 contracts per day last year to 360,000 this quarter. During European hours, from 11pm to 7am Central time, volume rose from 750,000 per day to 1.1 million per day, up almost 45 percent.

- Turning to our efforts in options, we remain the leader relative to other global exchanges with Q2 options rising 15 percent, and electronic options average daily volume rising 23 percent to 1.7 million contracts. In Q2, the percentage of options that traded on Globex reached an all-time high of 57 percent, up from 51 percent in Q1. We saw the highest electronic percentage to date in interest rates, energy and metals. Agricultural options reached a record quarterly ADV of 345,000, up 26 percent from the prior year. Lastly, in June we had the highest month ever in total weekly options products with 495,000 contracts per day, up 57 percent.

- Moving on to our Commodities portfolio – we had a very impressive quarter with energy, ags and metals each up more than 20 percent in revenue. We also set new records of Large Open Interest Holders in Metals and Ags, reaffirming that global customers continue to manage their commodities market risk exposures at CME Group. We track substitute products very closely, and we have outperformed peers in crude futures, crude options, natural gas futures, natural gas options, gold, and copper so far in 2016.

- Energy was particularly strong with Q2 average daily volume of 2.3 million contracts, and July has continued to be robust with volumes up 20 percent. In Q2, crude was up 38 percent, natural gas rose 17 percent and refined products increased 18 percent. The European and Asian activity in energy mentioned earlier highlights our extremely focused attention on our customers globally and the growing relevance of our product set. Growth in energy options has been meaningful - WTI options volume rose more than 20 percent to more than 180,000 contracts per day, while natural gas options were up almost 20 percent as well. Within energy options, we have grown from 49 percent electronic in Q1, to 53 percent in Q2, and up to 57 percent so far in this month. Energy ADV in the second quarter was the 2nd highest quarter ever, behind the record first quarter this year.

- Our Metals business during the quarter was phenomenal! Volume was up 41 percent and transaction revenues rose 35 percent. Our Precious Metals average daily volume was up 43 percent, while copper rose 33 percent versus a year ago. Options activity was strong, up 32 percent compared to last year. Metals had the 2nd best quarter ever, and we have outperformed substitute products at other exchanges by a significant amount. We were also able to achieve multiple all-time open interest records in Copper, as well as set the all-time record for Large OI holders in both Gold and Silver in July.

- Last, but not least, our agricultural business had its highest volume quarter in our history. Ag options rose 26 percent and futures were up 22 percent. Soybeans led the way, up 49 percent, while corn, soybean meal and hard red winter wheat each grew more than 20 percent. It is worth noting that there are increasing expectations of the likelihood of La Nina. We would expect that to impact both agricultural volumes as well as benefitting our natural gas markets.

- Turning to financial products, and starting with Interest Rates - average daily volume in Q2 was up 3 percent, and year to date we are up 7 percent. Within Eurodollar options, volume increased 28 percent during the second quarter. Recently, we have had progress developing liquidity and trading on the screen with the electronic percentage increasing from 23 to 25 percent from Q1 to Q2. Also, the electronic volume during the US hours when the pits are open continues to increase significantly. Fed Funds futures continue to be robust, as we have seen FED expectations move around before, during and after the Brexit vote. Fed fund futures averaged more than 142 thousand contracts per day in Q2, up almost 140 percent. In addition, we spoke about the successful launch of the Ultra 10-year product last quarter, and volume has jumped from 35,000 contracts per day to over 60,000, and July is tracking at that same level. We launched Swaptions clearing in the second quarter with 5 approved clearing members, and we've now cleared dealer-to-dealer and customer trades. In addition to Swaptions, our recently-launched Brazilian Real IRS clearing offering began scaling in June, and we've now had 24 participants who have cleared the product thus far.

- We continue to outperform other related markets indicating the proportion of activity shifting to our interest rate futures and options. For example, while we are up 7 percent year to date in interest rate volumes, global dealer-to-client swap clearing volumes are down 10 percent in the dollar fixed to floating market. We continue to capture market share in treasuries which we talked about before, as cash treasuries are down 5 percent, while our treasury futures are flat. Our open interest in rates continues to hit record elevated levels above 63 million contracts in March and June, while rate related open interest at most other exchanges peaked several years ago.

- Turning to Equities, ADV was up 25 percent in Q2 to almost 3 million contracts, and as I mentioned, we have had great participation from clients around the world. We had solid activity in equity options which grew 24 percent during the quarter. We were particularly pleased with the record of more than 440,000 equity options that traded post-Brexit before the US stock market even opened. In addition, last week we announced the launch of S&P 500 Total Return Index Futures and the S&P 500 Carry Adjusted Total Return Index Futures. These innovative products are intended to mimic the economics of a total return swap in futures form, allowing swap dealers and their end clients to avoid higher costs as a result of new swap margin rules that are expected on September 1st. This is another example of CME Group's ongoing commitment to meet the changing needs of our clients in an evolving global marketplace. The S&P 500 Total Return Index Futures will be available to trade via BTIC which is Basis Trade Index at Close, and will further expand the U.S. major index BTIC offering, which traded a record $32 billion in notional value during Q2.

- Lastly, our FX business was down 7 percent in Q2, as the trading environment was challenging pre-Brexit. So far this year, we have outperformed the 2 largest FX platforms in terms of trading activity vs. last year. Our FX markets performed very well during the post-Brexit day, when the markets were active and we had record British Pound activity with more than 500,000 contracts traded that day.

- Speaking of Brexit, we were very busy after the results came in, particularly during the pre-US hours. We had a record 350 million messages to process, and as the slide in our presentation shows, we handled it without any issues. This is a tribute to our hard working colleagues, who were ready to handle strong activity when volatility spiked.

- We have had a tremendous opportunity during the last few months to deeply engage with our global clients as market rules continue to evolve, with uncertainty post Brexit and also the upcoming implementation of margin for uncleared swaps. We have been talking to folks about the greater regulatory certainty under US regulation, and based on the results again this quarter it is clear customers on every continent are comfortable with the US regime. This was further solidified with recognition and permanent QCCP status in Europe that we received in June. The next potential catalyst for increased exchange trading and swaps clearing is in about 5 weeks, when the first phase begins in the interdealer market requiring daily Initial Margin and Variation Margin to be exchanged on the bi-lateral, non-centrally cleared portfolios in the US. There will be a 10 day margin period of risk that will be put in place for uncleared swaps and there will be less netting available, compared to the 5 day period for cleared swaps and generally 1 to 2 days for futures and options.

- Based on many client discussions, we are accelerating internal product development to try to create solutions that can provide relief for participants, including intermediaries and end clients.

- I mentioned the S&P 500 Total Return Index Futures launch prior to September 1st. Within our interest rate and FX areas, we are examining multiple new product ideas and looking at product construction. Within FX, opportunities we are working on include clearing for OTC FX options and non-deliverable forwards. In addition, within rates we believe this could be a catalyst for our Swaptions business, and we are getting inbound calls from customers about other ideas. Lastly, I mentioned Repo clearing last quarter, and we continue to make significant progress on the operational side in terms of technology and clearing, and we are working closely with large banks, asset managers and hedge funds. In addition, we are planning to be operationally prepared to launch fairly soon after regulatory approval.

- In summary, we continue to expand our global footprint and product offerings to create opportunities for our clients and our shareholders. We have worked hard to position the company for success, in a world that needs transparent, cleared solutions for risk management now more than ever.

- With that, I am going to turn the call over to John to discuss the financials. Thank you.

John Pietrowicz

- Thank you Gill, and good morning everyone. Our team has been intensely focused on driving global revenue growth, operating our business as efficiently as possible, and returning excess capital to our shareholders in a consistent manner.

- As Gill mentioned, we had another excellent quarter. Total revenue was up 11 percent compared to a very strong quarter in Q2 last year, with four of our six product areas delivering more than 20 percent revenue growth.

- Our adjusted expenses excluding license fees were flat with the second quarter of last year, so almost all of the incremental revenue dropped to the operating income line. Our adjusted operating margin expanded by 3 percentage points from a year ago and adjusted EPS was up more than 15 percent for the second quarter in a row.

- This quarter, we removed amortization from our adjusted results and we provided a summary of the impact on prior quarters both in our earnings presentation deck, as well as in the income statement trend file we post on our website. This change puts the reporting of our adjusted results in line with our US exchange peers.

- Our rate per contract for the second quarter was 78.2 cents, up from 75.6 cents in Q1, due primarily to a positive shift in product mix, which was slightly offset by the member/nonmember mix.

- Market data revenue was $103 million, up slightly from the prior quarter.

- Moving to expenses, excluding license fees and adjustments, our total expense was $270 million, exactly where we were in Q2 2015, which I am pleased to report along with the solid top line growth. For the first half of the year, on this basis we were at $534 million up about ½ of 1 percent. For the second half, I would expect expenses to be about $548 million. The increase from the first half is based on our heavier spend on customer related activity in Q4, and the acceleration of product development which Gill alluded to. We will be lower than our initial guidance at the beginning of the year, which included amortization and excluded license fees, by $4 million. Instead of being up 1 percent, we are guiding to a ½ percent increase on that basis.

- We ended the quarter with approximately 2,640 employees, up 40 from last quarter, driven primarily by entry level hires and hires in lower cost locations. Our compensation ratio from Q2 came in at 14.5 percent, and is down from 17 percent in Q2 last year.

- Looking at the non-operating income and expense line, our ownership in the S&P Dow Jones joint venture drove more than $27 million in net earnings from unconsolidated subsidiaries, up slightly from Q1.

- Turning to investment income, we received $2.6 million in dividends from BVMF. In addition, our investment returns generated through reinvestment of cash performance bonds and guaranty fund contributions during Q2 decreased sequentially to $5.2 million from $7 million in Q1. This is a result of lower average daily investment balances from the prior quarter, and our net return during Q2 was 9 basis points. While we have been approved to establish an account with the Fed for house cash, it is not live yet, and we continue to work through the operational details.

- Turning to taxes, for the quarter we ended at an adjusted 36.5 percent, which is where we guided.

- And now to the balance sheet – At the end of the second quarter, we had $1.34 billion in cash, restricted cash and marketable securities.

- During the second quarter, capital expenditures, net of leasehold improvement allowances were $20 million, as we continue to leverage more software and infrastructure as a service, which is included in expense. We originally guided to $115 to $120 million for the year. I am going to reduce that by $15 million to $100 to $105 million, based on efficiency efforts and timing.

- One final item I want to outline today is a new program we have available for equity members. These firms are required to hold shares of CME Group Class A common stock, in addition to seats to receive equity membership privileges. Under the terms of the program, participants may substitute the assignment of their required shares by paying us a monthly subscription.

- Currently, there are 370 institutions that are required to hold CME Group Class A common shares as part of their equity membership. A typical equity member is required to hold 20,000 shares per exchange in addition to seats.

- For most of the equity members, the subscription rate will be $7,500 per month per exchange. This will provide choice for the firms, and potentially allow them to free up capital to deploy in other ways.

- Each of the 370 firms will have full discretion on whether or not to participate in the program. The timing on their evaluation and decision to participate is expected to lead to an orderly share release over time and should be easily absorbed by the market.

- As it is unclear on the participation level, we will update you next quarter on the uptake. At a 50 percent participation level, we would generate an estimated $20 million of incremental annual revenue, and up to $40 million if all equity members switch to the monthly subscription.

- In summary, I am very pleased with the hard work this quarter across the entire business. Our secular growth drivers continue to deliver results with or without volatility, our efficiency on expenses has been excellent and since the first of the year we have returned $1.4 billion in dividends.

- With that, we'd like to open up the call for your questions. Given the number of analysts who cover us, we ask that you limit yourself to one question, so we can get to everyone. Please feel free to get back into the queue, if you have any further questions. Thank you.

our industry, such as any changes to regulations and policies that require increased financial and operational resources from us or our customers; the costs associated with protecting our intellectual property rights and our ability to operate our business without violating the intellectual property rights of others; decreases in revenue from our market data as a result of decreased demand; changes in our rate per contract due to shifts in the mix of the products traded, the trading venue and the mix of customers (whether the customer receives member or non-member fees or participates in one of our various incentive programs) and the impact of our tiered pricing structure; the ability of our financial safeguards package to adequately protect us from the credit risks of clearing members; the ability of our compliance and risk management methods to effectively monitor and manage our risks, including our ability to prevent errors and misconduct and protect our infrastructure against security breaches and misappropriation of our intellectual property assets; changes in price levels and volatility in the derivatives markets and in underlying equity, foreign exchange, interest rate and commodities markets; economic, political and market conditions, including the volatility of the capital and credit markets and the impact of economic conditions on the trading activity of our current and potential customers; our ability to accommodate increases in contract volume and order transaction traffic and to implement enhancements without failure or degradation of the performance of our trading and clearing systems; our ability to execute our growth strategy and maintain our growth effectively; our ability to manage the risks and control the costs associated with our strategy for acquisitions, investments and alliances; our ability to continue to generate funds and/or manage our indebtedness to allow us to continue to invest in our business; industry and customer consolidation; decreases in trading and clearing activity; the imposition of a transaction tax or user fee on futures and options on futures transactions and/or repeal of the 60/40 tax treatment of such transactions; and the unfavorable resolution of material legal proceedings. For a detailed discussion of these and other factors that might affect our performance, see our filings with the Securities and Exchange Commission, including our most recent periodic reports filed on Form 10-K and Form 10-Q.