CME Group – Q116 Earnings Call Prepared Remarks

Phupinder Gill

- Thank you Mr. Peschier, and thank you all for joining us. It was an exceptional start to the year with record quarterly average daily volume, which was up 13 percent compared with an already strong first-quarter last year. We had very balanced growth in both financial and commodity products, each up double digits. We track customer segment activity closely and in Q1 we had more than 10 percent growth from asset managers, hedge funds, corporates, proprietary trading firms and retail clients during the quarter. Volume from banks was up 1 percent, which is strong relative to their decrease in their overall trading businesses over each of the last few years.

- More recently, April activity has been fairly strong compared to last year and is up more than 20 percent in total. It is encouraging to see relatively good volumes, as April has been our slowest month over the last 2 years. Open interest remains elevated and is up significantly since the beginning of the year.

- 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 are very pleased with the tremendous results from outside the US during the first quarter. We had record quarterly non-US volume by far, as well as the highest proportion of the business from outside of the US since we started tracking the information, with more than 25 percent in first-quarter compared to 23 percent in the first quarter last year.

- In Europe, we had a very strong first-quarter activity with volume increasing 28 percent from 2.3 million contracts per day last year to more than 2.9 million per day this year. The increase was led by equities which jumped 70 percent and energy was up almost 60 percent. In Asia, energy was up 75 percent and equities grew by about 70 percent, with metals rising more than 30 percent.

- Focusing on Asia for a moment – we have been discussing the opportunity to expand our user base to include Chinese firms and entities for many years. Our focus started primarily with intermediaries and we are now engaging directly with asset managers, hedge funds and other entities there. We generally look at our trading data in terms of what we see through mainland China, Hong Kong and Taiwan. In Q1, we reached approximately 200,000 contracts per day combined, which is up from 100,000 contracts per day in Q1 of 2014, and 125,000 contracts last year. Our most notable recent success is in our energy franchise where we have seen mainland China average daily volume increase from less than 10,000 contracts in the middle of last year, to more than 30,000 contracts in Q1. A highlight from Hong Kong activity is in our equity business, with average daily volume there more than doubling to almost 25,000 contracts per day in Q1. The surge in volume is great to see, and we are very fortunate to have highly appealing products to offer these clients. Based on the challenges in China over the last year, we believe many of these firms are comfortable trading in our regulated markets and benefitting from the significant liquidity we have around the clock.

- Speaking of that, in addition to the country of origin information we share with you, we also track electronic volume throughout the 24-hour trading day. In Q1, volume during Asian hours grew by almost 30 percent, while activity during European hours rose 60 percent. Liquidity begets liquidity, and we are displaying deeper electronic markets in both futures, and more recently, options around the clock.

- Turning to our efforts in options, we remain a strong leader compared to other global exchanges with Q1 options volume hitting a record 3.5 million contracts per day, which is up 22 percent, with electronic options average daily volume rising 26 percent to a record 1.8 million contracts. The continued electronification of our options franchise has enabled us to further globalize participation in our Options markets, with our European Options volume up 36 percent and Asian Options volumes up 25 percent in Q1. Our continued investment in systems enhancements, new products and client education are driving significantly increased usage of our Options products from end users, with volumes from Hedge Funds and Asset Managers up 34 percent and up 29 percent respectively.

- A couple of quick points on our financial and commodity products.

- Starting with Interest Rates - volume rose 9 percent to more than 8 million contracts a day, and revenue increased by 14 percent, with Eurodollars leading the way. We hit record levels of open interest in Q1 in our rates business driven by Eurodollar options and Treasury futures which hit all-time highs. We also had very strong options activity with the highest quarterly volume ever, and reached a record percentage of the options trading on Globex in March, with 71 percent electronic in Treasuries and 25 percent electronic in Eurodollars. So far in April, the electronic percentage in Eurodollar options has grown to 27 percent.

- On the product development front, we mentioned our launch of the Ultra 10 year contract on our last earnings call. This product has continued to gain momentum and has attracted attention with several articles written over the last month related to this innovative new product. In addition, we are pleased that we cleared our first Swaptions trade earlier this month, and we think this is yet another example of innovating and being first to market with a customer led solution. We held a swaptions customer webinar that attracted over 500 participants with significant follow up discussions, and we had a number of productive client events related to the product. Our dollar rate swaps market share reached the highest level in March that we have seen over the last 6 months, and we had a 15 percent pickup in revenue capture in swaps clearing versus Q4 last year. Lastly, we are actively involved with a working group of intermediaries and customers on a potential Repo clearing offering. As that develops over the next quarters we will share additional information.

- Turning to Equities, we are pleased with the start of the year with Q1 volume up 28 percent and April up more than 30 percent. We have had solid activity in equity options which grew 20 percent during the quarter. In Q1, our S&P 500 options market share versus CBOE expanded to 29.4 percent from 27.8 percent last year. Open interest in equity options rose 13 percent compared to the prior year and our new BTIC order type continues to perform well and traded 20,000 contracts for the first time on March 31st.

- Moving on to our Commodities Portfolio – these business lines overall were up 13 percent. Energy has been particularly strong with record Q1 average daily volume of 2.5 million contracts, and April has continued to be robust with volumes up almost 40 percent. WTI futures had a record quarter averaging about 1.2 million contracts per day, and gasoline futures activity was also at a record level. I mentioned options earlier, and within energy we had record WTI options volume of over 200,000 contracts per day and more than 145,000 contracts per day on Globex. Our natural gas options were up 38 percent during the quarter, and we had a record percentage of volume traded electronically there. Additionally, we set a record number of Large Open Interest Holders in our Energy futures in Q1.

- Our Metals business was also a standout in the first quarter with volumes up 23 percent. Our Precious Metals average daily volume was up 26 percent, led by options which rose 36 percent in Q1. As many of you know, we have made significant inroads into base and ferrous metals businesses, and we continue to expand our presence in these key growth areas. Our copper business is up 11 percent and we hit a new open interest record during Q1. We continue to outperform our primary competitor in this market, where we have posted faster growth in copper in each of the last 5 quarters. In Aluminum, we continue to expand our suite of aluminum offerings, achieving record volumes and increasing our Open Interest 5-fold in the last 12 months. And in iron ore, leveraging our customer value proposition of global electronic trading of futures and options, and customer anonymity, we have had growing open interest and a record trading day of almost 13,000 contracts. We have now achieved iron ore market share of 10 percent in Q1, up from just 3 percent in 2015, as we continue to successfully expand and diversify our global suite of Metals products.

- Finally, Agricultural products have been particularly strong in April, and are tracking toward a monthly average daily volume record for the month, after a slow start to the year. Trading has taken off based on production uncertainty in South America where wet conditions in Argentina and dry conditions in Brazil are causing concerns. We had two consecutive record trading days last week in the overall complex with almost 3 million contracts, including record soybean product volume above 1.5 million contracts on one of those days. Electronic ag options are surging, up from near 130,000 in April last year to more than 250,000 daily so far this April. Importantly, open interest in soybean and corn futures are up 16 percent and 8 percent respectively from last year. Finally, last week we reached an all-time high in large open interest holders in agricultural products.

- In summary, we continue to work with our customers on bringing innovative risk management solutions to the marketplace, and our product diversity is unparalleled. John will touch on our progress to continue to streamline our infrastructure costs, to reallocate our expenses to growth initiatives and to further innovate in our businesses.

- 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 3 things – driving global revenue growth, operating our business as efficiently as we can, and returning excess capital to our shareholders in a consistent way.

- As Gill mentioned, we had a tremendous start to the year with strong and balanced revenue growth. Total revenue was up 11 percent compared to a very strong quarter last year, while total adjusted expense rose just 3 percent. Our adjusted operating margin expanded to 65 percent and adjusted EPS of $1.15 was up 17 percent.

- Our rate per contract for the first quarter was 75.6 cents, down 4 percent from 78.9 cents in Q4, as our overall ADV rose 29 percent sequentially. The biggest impacts were member vs. nonmember mix and volume discount tiers this quarter due to the large increase in activity. Compared to the fourth quarter, our members' volume grew 30 percent and nonmembers jumped 23 percent. In addition, we had higher volume discounts in Q1 relative to Q4 as a result of significant growth in certain products.

- Market data revenue was up 4.5 percent compared to Q1 last year and in line with our guidance. We continue to monitor this line carefully as we are seeing some rationalization as we bring all customers in line with the full priced offering, and we are seeing some screen declines due to recent bank staff reductions.

- Adjusted operating expenses for the quarter totaled $327 million, up 3 percent driven primarily by an $8 million increase in licensing and other fee agreements. Excluding license fees, our total expense year over year was approximately flat, and as a reminder our annual guidance was a 1 percent increase on that basis.

- We ended the quarter with approximately 2,600 employees, with the majority of the hiring done in India and Belfast, which is part of our plan to reduce technology expense while improving service by staffing in those lower cost locations and reducing contractors. Our compensation ratio for Q1 came in at 14.1 percent compared to 16.1 percent for the full year of 2015.

- Looking at the non-operating income and expense line, our ownership in the S&P Dow Jones joint venture drove more than $26 million in net earnings from unconsolidated subsidiaries, which was up 13 percent from the prior year. We are pleased with the investment we made in the index business, while also assuring we continue to offer the world's leading index futures products on CME.

- Now turning to investment income. We had a meaningful increase in investment income driven almost entirely by the returns generated through reinvestment of cash performance bonds and guaranty fund contributions. The rise in short-term rates at the end of the year resulted in an increase in investment income of $17 million. During Q1, we had returned approximately $10 million of that to clearing firms, which is displayed on the income statement under other non-operating expense. This amount is anticipated to increase as our investment returns grow.

- We recently received approval to establish an account directly at the FED. At this point the account will only be for clearing firm house positions held in cash.

We are currently in the process of operationalizing the accounts with the FED. When effective, we expect to pass a higher rate to clearing members for their house positions than we do today. Cash held in segregated customer accounts will continue to be invested through commercial banks and US treasury securities as they are now. We expect that the house accounts will be operational in the next month or so. As in the past, we plan to continue to pass through the majority of the earnings back to the clearing members.

- Turning to taxes, for the quarter we ended at 36.3 percent, slightly below our guidance.

- And now to the balance sheet – during Q1 we paid almost $1.2 billion in dividends to shareholders including our variable dividend and the first regular dividend. At the end of the first quarter, we had $1.33 billion in cash, restricted cash and marketable securities. We added $130 million during the quarter driven by the sale/leaseback transaction of our data center with Cyrus One.

- During the first quarter, capital expenditures, net of leasehold improvement allowances were $16 million, as we continue to leverage more software and infrastructure as a service, which is included in expense.

- We continue our intense focus on efficiency. With the sale of our office buildings over the last few years, and more recently our data center, we are taking an asset light approach, which will allow us to focus on running our core business. In 2015, we delayered the management structure, closed futures pits, reduced marketing costs, and focused on data center consolidation. So far this year, we have completed the sale of our data center, sublet excess office space in Chicago, announced the closure of our trading floors in New York at year end, and have begun to offshore some positions reducing compensation and consulting costs.

- With the sale and leaseback of our data center, we will continue to operate our trading and clearing functions as well as our colocation business and we will continue to receive the corresponding collocation revenue. From an earnings perspective this transaction is approximately neutral. In terms of expenses, we will see a net reduction in total quarterly expense of about $1 million primarily in depreciation, and we expect a corresponding increase under interest expense.

- Turning to the New York floor, we will save approximately $5 million of expense annually beginning in 2017, and possibly another $3 million per year if we can successfully sublease the space.

- In summary, I am very pleased with the hard work this quarter across the entire business. As you know, operating leverage in our business is significant, and this was clearly evidenced by the margin on incremental revenue of approximately 90 percent. We have outlined many positives going forward, including building liquidity around the clock and from around the world, innovating new products, getting access to the Fed accounts, which should benefit both our intermediaries and our shareholders, and continuing to focus on our efficiency strategy.

- 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.

Therefore, actual outcomes and results may differ materially from what is expressed or implied in any forward-looking statements. We want to caution you not to place undue reliance on 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. Among the factors that might affect our performance are increasing competition by foreign and domestic entities, including increased competition from new entrants into our markets and consolidation of existing entities; our ability to keep pace with rapid technological developments, including our ability to complete the development, implementation and maintenance of the enhanced functionality required by our customers while maintaining reliability and ensuring that such technology is not vulnerable to security risks; our abilityto continue introducing competitive new products and services on a timely, cost-effective basis, including through our electronic trading capabilities, and our ability to maintain the competitiveness of our existing products and services, including our ability to provide effective services to the swaps market; our ability to adjust our fixed costs and expenses if our revenues decline; our ability to maintain existing customers, develop strategic relationships and attract new customers; our ability to expand and offer our products outside the United States; changes in domestic and non-U.S. regulations, including the impact of any changes in domestic and foreign laws or government policy with respect to 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.