Q108 Earnings Call Prepared Remarks
Apr. 22

John

Thank you for joining us. Craig Donohue, our CEO, and Jamie Parisi, our CFO, will spend a few minutes outlining the highlights of the first quarter, and then we will open up the call for your questions. Terry Duffy, our Executive Chairman, and Rick Redding, our head of products and services, have also joined us this morning 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 accompanying 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, including our most recent Form 10-K, which is available in the Investor Relations section of the CME Group Web site.

During this call, we will refer to GAAP and non-GAAP pro forma results. A reconciliation is available in our press release, and there is an accompanying file on the investor relations portion of our Web site that provides detailed quarterly information on a GAAP and Pro forma basis.

Now, I would like to turn the call over to Craig.

Craig

- Thank you for joining us this morning. With the backdrop of significant unrest in global financial markets and a challenging environment for many financial services companies, the CME Group continued to execute on our business plan and deliver significant top line growth.

- Total average daily volume of 13.7 million contracts grew by more than 32 percent on a pro forma basis compared with the prior year, with every product line up more than 15 percent.

- It is important to note, we have generated strong volume growth every year since we demutualized, with changing economic backdrops. We went into a recession in 2001 and came out of it, we have seen flat yield curves/steep yield curves, rising interest rates/falling interest rates, an active Fed/an inactive Fed, and strong volatility/decreasing volatility. The steady growth throughout all our product areas, we believe has been driven by secular shifts, and importantly, by many of the critical initiatives we embark on to expand our business. Those include our continuing efforts to expand our customer base, improve the speed and functionality of our systems, and develop innovative new products and markets.

- So what did we do this quarter? First, we successfully integrated the CBOT products onto Globex in January. We did so in two phases, first on January 14th, we added CBOT commodity and equity volumes, followed by January 28th, when we added the CBOT treasury and other interest rate products to CME Globex. In February, we broke multiple electronic records in treasury and agricultural products. Also, in February we completed our transaction with BM&F, significantly enhancing our opportunities in South America. At the end of February and beginning of March, we implemented several speed enhancements which reduced our average response times from 29 milliseconds in Q4, when we handled 109 million orders per day, to 23 milliseconds in Q1 of 2008 when we handled 194 million orders per day. During the month of March we averaged under 15 milliseconds.

- We have successfully consolidated the equity floor based products to the CBOT location, and will move interest rate products next week. Finally, we will complete the floor transition when we move the CME agricultural products in May. At that point, the integration will be virtually complete within 10 months of the close of the transaction.

- On March 17th, we announced our agreement to acquire the New York Mercantile Exchange. We are currently in the process of preparing the Joint Proxy Statement/Registration Statement which will be filed with the Securities and Exchange Commission shortly. At the same time we are proceeding with the review process under the Hart Scott Rodino Act to obtain the necessary antitrust clearance to proceed with the transaction. We expect to complete the transaction by the end of 2008.

- At the end of March, we completed an acquisition of Credit Market Analysis, a leading provider of credit derivatives market data. This move will provide CME Group with greater exposure to the rapidly growing $62 trillion in notional outstanding credit derivatives market. It offers the potential to leverage CME Group's clearing and trade execution capabilities, enhancing CMA's products to create greater value and efficiencies for its customers.

- Before I turn the call over to Jamie, I would like to update you on one aspect of our growth strategy which is to increase global penetration, and I will also provide my perspective on the current trading environment.

- First, on the global front, in our view we are at the very early stages of penetrating what we believe will be a significant source of future business. While it is difficult for us to measure exactly where our trading volume originates, as many global firms connect through private global networks, there is some data available that gives a sense of our progress. We have seen strong volumes coming through our International hubs, which in the first quarter amounted to 930,000 contracts per day up 76 percent compared to Q107, representing about 7 percent of our overall volume. Our hub in Singapore facilitated volume growth above 100 percent. Another measure we can look at is the time of day that trades are executed. In Q1, approximately 16.3 percent of our volume came during non US trading hours, up from about 12.8 percent a year ago. While we are pleased with the results to date, we also see the opportunity to more significantly enhance our capabilities in Europe, Asia and South America.

- I mentioned the BM&F transaction, and one of our main objectives there is to significantly increase the distribution of CME's global benchmark products, like agricultural products, treasuries, fx and equities, and eventually energy products. We have recently hired a seasoned executive to run our Latin American operations helping to drive growth from that expanding region.

- One of our major objectives in 2008 is to expand our global reach and build on the non-US volume I referenced earlier, through more effective cross selling and leveraging customer relationships. Our strategy is to enhance our sales and marketing capabilities in Europe, Asia and Latin America, with our product sales group linked tightly within our regional structure. We will also be adding resources in product research and business development in order to enhance our capabilities.

- As we expand our customer base, we are also spending more time considering where large sources of capital will come from as we look out five to ten years from now and how to effectively market our product offerings and capabilities. One significant source of activity is expected to come from sovereign wealth funds. Over the last 6 months, we have increased our marketing and sales efforts to these groups The International Monetary Fund recently estimated that the current funds controlled by

Sovereign Wealth Funds would quadruple from $2.5 trillion now to $10 trillion by 2012. We expect the future trading to come from trading units directly controlled by the sovereign wealth funds or through allocated capital deployed to traditional trading firms around the world.

- Now, I would like to briefly address the question of the impact of deleveraging on current and future trading volumes. The topic first came into play beginning in August of last year, and continues to be an area of discussion.

- There are a three major points that lead us to the conclusion that while deleveraging has impacted some markets, there is no evidence it will inhibit our ability to sustain our growth rates since we demutualized. We have spoken to numerous end customers, FCM's and settlement banks and their views about current and long-term volumes in our listed derivatives markets are optimistic.

- The three important considerations include the makeup of our customer base, the capital efficiency of the central counterparty model including lower financing costs compared to securities and OTC markets, and the benefits of risk mitigation and transparency.

- It is important to understand our customer base and their business effects on both our volumes and open interest. Over 80 percent of our current volume comes from the buy side primarily made up of algorithmic trading firms, hedge funds, and asset managers, and other buy side participants. The algorithmic trading segment had significant volume growth during the quarter, and based on our discussions with many of them, they have been beneficiaries of the market volatility. These players utilize strategies that are not capital intensive, and generally they move in and out of the market, without holding meaningful open interest. Another major volume segment is comprised of large established hedge funds, including Global Macro hedge funds, and as we look at their growth, we also see healthy activity. Bank proprietary trading volumes overall had growth rates just under our overall average. Banks are looking at ways to adjust their balance sheets and decrease risks, and our products allow bank traders to do just that.

- Turning to capital efficiency. We clearly have an advantage relative to securities and OTC markets, which is important as credit becomes tighter. Unlike the OTC and securities markets we are able to provide efficiency due to our twice daily mark to market and performance based margining structure. We also provide cross margining and multilateral netting advantages, unlike the OTC market. Since August, banks have had to become more selective in terms of capital or margin in the prime brokerage part of their OTC businesses. Many firms without the same access to capital from their prime broker, are turning to the futures market. Several FCM's we have spoken to recently are seeing new users like these accessing the futures market, which benefits the futures divisions of many investment banks, as well as the exchanges.

- The third point is our markets stand out from the OTC markets based on a real time and transparent pricing mechanism, and the credit risk mitigation available through our central counterparty model. Many problems beginning in August in structured OTC markets revolved around the lack of reliable pricing data, and a lack of real liquidity. Many of these structured products don't have a viable exchange market to lay off risk. In our markets, users can trade with all counterparties, and our pricing is available in real-time on primarily electronic markets to prevent hidden risk. It is important to note, that we have never had a default due to counterparty exposure in our history. This issue is currently resonating with the end customers we have spoken to, who have commented on the safety, transparency, and the significant liquidity of our markets.

- In summary, these points are critical to understand why we believe that deleveraging in certain market segments will not have the same impact on our markets. The high velocity algorithmic traders tell us their business is healthier than ever, and they encourage us to continue innovating the way we have, to improve our technology capabilities, so they can have more inputs which drive their trading behavior. Many of the larger hedge funds, have a proven track record and could be likely beneficiaries as their customers decide where to allocate capital. We expect the largest hedge funds to continue to get bigger. Finally, the investment banks have a need to trade in the most efficient way from a balance sheet perspective, and we believe they see the benefits of our markets. We also believe that we can work with them to provide solutions that end customers demand in terms of additional products, either traded or cleared that can benefit each of us. While some may be interested in taking less proprietary risk, they are also looking for ways to increase their agency business.

- In terms of our continued overall growth. We believe the secular trends of greater need for risk management, growing investor sophistication, a compelling value proposition compared to OTC markets, and continued growth in sources of capital, all remain firmly in place. In addition to these secular trends, we also will continue to enhance our ability to grow, through more significant global penetration, continued product and technology innovation, additional transaction processing opportunities, like BM&F, and growth in our options businesses. In our view, we are better positioned to take advantage of the opportunities that present themselves in the next 5 years, than we were 5 years ago.

- With that let me turn the call over to Jamie.

Jamie

- Thank you Craig.

- I am happy to report that CME Group posted another record quarter financially. Our operating income, both on a GAAP and a pro-forma basis, exceeded the previous records set in the third quarter of 2007. The operating leverage inherent in our business model is alive and well – the margin on incremental revenues compared to Q107 was 97% on a pro-forma basis, while our customers enjoyed lower average fees and the efficiencies we have delivered to them as a result of the CBOT merger.

- The **GAAP results** for the first quarter were outlined in detail in the press release. In summary, we delivered net income of $284 million or $5.25 per share. Included within these results were $8.7 million of CBOT merger-related operating expenses, $8.4 million of transaction costs related to the BM&F agreement, $3.8 million related to the acquisition of CMA, and an $8.4 million reduction of non-operating expense related to the CBOE ERP guarantee. We provided a reconciliation between GAAP and pro forma results in the back of the press release, and we have also posted both GAAP and pro forma historical quarterly income statements on our Web site. We exclude costs associated with mergers and acquisitions we have completed when generating our pro-forma financial statements.

- As I move on to the details of the income statement, please note that the comparisons I reference are based on the **pro forma results**.

- Our **total pro forma revenue** rose 25 percent to $625 million in the first quarter, driven primarily by strong CME Group volumes. **Average daily volume** was up 32 percent, led by equity volume up 66% versus last year, while the average rate per contract was down 1.6 percent.

- Our **average rate per contract** was 63.0 cents in Q1, down from 64.0 cents in Q1 last year, and down from 64.8 cents in the fourth quarter of 2007. These decreases are due primarily to faster growth in lower fee member volume vs. higher fee non-member volume.

- **Quotation data fees** were $57 million for the quarter, up 13 percent from Q1 of 2007. At the end of the quarter, we had approximately 300,000 users who subscribed for the base devices, up approximately 7,000 compared to the end of the year. In January of 2008, we increased our fee per market data screen from $50 to $55. While we have not yet seen any signs of weakness, with the recent announcements of layoffs on Wall Street, our user count may be impacted.

- Our first-quarter **processing services revenue** was $17.5 million, up 35 percent. In Q108, we handled more than one million NYMEX contracts per day, up from 850,000 in the fourth quarter. In Q1, revenue from NYMEX totaled $17 million, which averaged 27 cents per contract. This is at the high end of the RPC guidance we had given some time ago for this arrangement.

- I'll now take a few minutes to review **expenses**.

- **Total pro forma operating expenses** for Q1 were $214 million, up 2 percent versus Q1 last year. The increase in our license fee expense, which is tied directly to equity volume increases, accounted for 75% of the overall expense increase. In addition, we are hitting our cost synergy targets. In Q1, we realized $22 million of **synergies** as a result of our merger with CBOT. On an annualized basis, this equates to $87 million, so we are more than half way to the run rate of at least $150 million by year-end.

- **Total compensation-related expense** was down $5 million compared to Q1 of 2007, and increased $1.5 million sequentially to $73 million, which is lower than our normal Q1 compensation increase. There are three components of this expense: salaries and benefits, bonus and stock-based compensation. Salaries and benefits totaled $57 million, up $3 million sequentially. As of March 31st, the CME Group headcount stood at 1990, up 20 since the beginning of the year. This increase includes 50 employees from our acquisition of CMA and a reduction of 30 positions due to the CBOT merger. Taking a look at our remaining transitional employees related to the CBOT merger, we expect an additional reduction of 110 employees this quarter and the final 20 in the second half of the year. In terms of ongoing headcount growth, we plan to add positions in marketing, sales, technology and business development, much of which is tied to building a more significant employee presence globally as Craig mentioned. Next, our employee bonus accrual totaled $10 million, down $1 million versus Q4. Remember, the annual bonus is tied to a cash earnings target that we set well above the 2007 actual result. And finally, the stock-based portion of compensation was $6.3 million, which was down $400,000 relative to the prior year.

- We often get asked if operating margins can continue to expand. I believe the first quarter was solid evidence that the answer to that question is yes. **Operating margin** was 66 percent on a pro forma basis, which was our best quarter ever and well above 58 percent in the first quarter last year.

- **Non-operating income** was down in Q1 vs. Q4. This resulted primarily from decreased investment income which was down $6 million sequentially driven by lower rates of return. Between cash and marketable securities and clearing house balances, the average daily balance of $1.4 billion in Q4 increased to $1.6 billion in Q1, but the average annual rate of return dropped from 4.1 percent to 3.3 percent. In addition, due to the performance of the equity market, there was a negative impact sequentially on deferred compensation earnings of $1.8 million. Lastly, during the first quarter, we instituted a foreign currency hedge to mitigate the FX risk in our BM&F position which resulted in a decrease in investment income of $2.2 million. Generally, due to the time decay of the option, the hedge will reduce investment income by approximately $3 million per quarter on average. Additionally, the value of the hedge will fluctuate due to changes in volatility, relative interest rates and the spot value of the Real vs. the Dollar. As of 3/31 the book value of our investment in BM&F is approximately $630 million and the current market value is approximately $792 million.

- For the first quarter, the **net securities lending** results totaled approximately $5.4 million. The spread between the average rate earned and the average rate paid remained abnormally high during the first quarter of 2008 due to the combined effect of changes in the federal discount rate and an increase in market demand for the securities we had available to lend through this program. Beginning in late March 2008, we temporarily suspended our securities lending program due to dislocations in the markets. We continue to review the program, and will resume it when we feel it is prudent to do so.

- Our pro-forma **pre-tax income** was $420 million in Q1, up 36 percent from the first quarter last year. **Net income** for the quarter was $291 million and **diluted pro forma EPS** was $5.39. In the quarter we had a tax benefit of $38.6 million due to a change in the Illinois state tax treatment for apportionment of revenues sourced within the state. Excluding the tax benefit, our Net Income would have been $252 million and diluted EPS would have been $4.67.

- Moving on to the **balance sheet**:

- As of March 31st, we had $1.2 billion of cash and marketable securities, and short-term debt of $165 million, resulting in a net cash position of approximately $1.1 billion. Cash earnings for the quarter was $299 million, another record for CME Group.

- Capital expenditures, net of leasehold improvement allowances, totaled $33 million in the first quarter, driven by $22 million of technology investments, $9 million of merger integration efforts including trading floor and Globex conversions, and $2 million of construction related to staff space.

- In the first quarter, we completed the acquisition of CMA for approximately $100 million. In terms of an impact to our income statement for the remainder of the year, we expect approximately $18 million of expense of which $8 million is amortization of intangibles. The increase in expense is in addition to our previously stated pro forma expense guidance of $835 to $850 million for 2008, and puts us into a range of $855 to $870 million. With respect to revenue from CMA, we expect it to exceed $10 million for the remainder of the year, and it will be reflected in the quotation data fees line.

- So far in April we are averaging 10.7 million contracts per day, up approximately 33 percent compared to last year. Growth rates in each product line for April compared to last year are consistent with the growth rates we experienced in the first quarter of 2008.

- With that, we would now like to open up the call for your questions.