Q212 Earnings Call Prepared Remarks
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John

Thank you for joining us. Phupinder Gill and Jamie Parisi will spend a few minutes outlining the highlights of the second quarter and then we will open up the call for your questions. Terry Duffy, Kim Taylor, and Derek Sammann are on the call as well.

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 Forms 10-K and 10-Q, which are available in the Investor Relations section of the CME Group Web site. Also, note the final page of our earnings release contains a reconciliation to our GAAP results this quarter.

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

Gill

- Thank you for joining us this morning. I will discuss our performance in the second quarter, and provide updates on a few of our strategic initiatives, before turning things over to Jamie to review the financials.

- During the second quarter, several themes continued to unfold, including the European crisis, bank downgrades, the continuation of Operation Twist and the Fed's zero interest rate policy. The environment we operate in remains challenged and global trading volumes continue to be impacted by low levels of volatility. In light of this, the entire organization is working to be as efficient as possible. Average daily volume in the quarter was 12.4 million contracts, down 9 percent versus the second quarter 2011. However, we did experience better volumes in May and June, 13.2 million and 13.1 million, respectively, which helped offset a slower April of 10.7 million contracts per day.

- Interest rate ADV in the second quarter 2012 declined 20 percent versus the same period last year. Volumes continue to be impacted by the Fed's zero interest rate policy and quantitative easing. The expectation of continued slower growth in the U.S. has pushed out the Fed Funds rate hike expectations which also continue to weigh on volumes. Helping to stabilize our interest rate complex is the growth out the curve, especially, in years 3 through 5, as well as in the Mid-Curve options.

- Our Interest Rate team has been successful in building this new liquidity, and we expect it to thrive even when activity on the front end picks up again. This is a good example of how we leverage our people and our products for the benefit of our customers, making CME Group the most compelling place to manage interest rate risks. This is evident in the strong outperformance of our markets versus interest rate products listed by other exchanges.

- Also during the quarter, FX volume was flat compared to the same period last year. Overall June ADV was 1.1 million, the highest FX volume month of 2012. This was driven by a boost in our Euro currency volume resulting from increased volatility going into Greek elections. Our key growth contributors continue to be the “Commodity Currencies” of the Australian Dollar, the Canadian Dollar and the New Zealand dollar, as well as our Emerging Markets products led by the Mexican Peso. This is a good example of how our FX business continues to diversify as we grow our entire portfolio of currency pairs. This was also a key driver of CME Group’s Q2 outperformance versus some of the larger cash FX platforms, most notably ICAP’s EBS platform reporting Q2 results down 24 percent compared to the prior year. We also hit multiple open interest records in June leading up to the June quarterly expiration, hitting an all-time high of 2.3 million open FX contracts on June 7, 2012. We finished June with open interest up 22 percent year-over-year. Overall, volatility remains slightly elevated going into the post-Greek election market, so we expect that we may see continued levels of concern as focus now turns to the Greek coalition government actions as well as the fate of Italy, Spain and Portugal.

- Equities volume was up 3 percent versus last year. The increase was driven by strong performance in E-mini Dow Futures, E-mini S&P options, E-mini S&P 500 weekly options, and E-mini S&P 500 End-of-Month options. While assets under management continued to decline during the quarter, volatility picked up briefly when U.S. markets rallied sharply at the end of the quarter after the better-than-expected news from the E.U. Summit. The VIX hit a high level of 27 intra-month, and has trickled down to close the month out near the 17 level.

- Energy ADV was down 1 percent versus last year. This was driven by strength in Natural Gas and Refined Products, offset by lower WTI trading volumes. However, we have experienced strong volumes in the month of July with ADV up 9 percent versus July last year.

- We also recently launched the CME Direct platform for energy trading in June to address customer needs for straight-through-processing. This new technology offers side-by-side trading of exchange-listed and OTC markets. CME Direct will initially support trading of CME Group's benchmark energy futures markets alongside OTC energy swaps through leading inter-dealer brokers.

- Although metals volume is down 8 percent for the quarter versus last year, metals open interest continues to grow, up 9 percent at the end of June versus the same period last year, driven by an 11 percent increase in Gold. We are encouraged by recent base metal volumes, with Copper average daily volume increasing more than 57 percent versus Q2 2011, and now representing more than 21 percent of our metals volume.

- In agricultural commodities, volume is up 11 percent from last year. Severe drought conditions in the Midwest, driving higher volatility, along with the expansion of the CBOT Grain and Oilseed trading hours on Globex, have both contributed to strong performance. Our markets have been particularly active in July with volumes up more than 50 percent as customers turn to us to manage their risk. Open interest has also grown from 6.1 million open contracts at the beginning of January 2012 to 8.7 million open contracts on July 25, 2012, which represents a high for the year and growth of over 20 percent versus the same period last year.

- Moving on to our growth initiatives, we continue to expand and enhance our global partnerships. During the quarter, DOJ approved our S&P Dow Indexes joint venture with McGraw Hill, and we closed the transaction. Combining S&P's leading position in equity, commodity, real-estate, and strategy indexes with Dow Jones' recognized strengths in equity, commodity, emerging market, target date, and dividend indexes, provides an opportunity to offer a complete and growing index family in more assets classes, benefiting more investors throughout the world. As a result of this venture, we have also extended our exclusive right to list for trading and clearing futures on S&P products for as long as we own equity in the joint venture.

- Turning to technology - In Q3 of this year, we will launch a significant CME Globex performance release. The new platform introduces advanced order entry and market data gateways deployed on our jointly developed PUMA network to provide improved processing speeds, decreased variability and significant hardware efficiency. This will provide a more consistent trading experience for all of our electronic trading customers with a significantly reduced server footprint while increasing capacity on peak. As we execute our long-term CME Globex strategy, we also maintain focus on cost and efficiency. Through continual improvement and the elimination of legacy systems, we have been able to keep technology-related expenses essentially flat, lowering technology costs as a percentage of total operating expense from approximately 35 percent in 2008 down to approximately 27 percent this year.

- Over the last 4 years, the CME technology division has been executing our long-term CME Globex strategy to evolve the trading platform around the customer experience. We defined a carefully planned roadmap to globalize our infrastructure, provide critical market controls, and move to a more efficient and less expensive hardware platform while maintaining the highest levels of reliability, integrity, and trust.

- In that timeframe, we successfully completed the migration of our legacy electronic matching engine to a modern, distributed computing platform for increased performance and efficiency. We also built our state of the art, next generation datacenter and migrated all of CME Globex to prepare for the launch of CME Co-location services, which went live earlier this year. We have also expanded our global distribution to enable the business growth we have seen internationally with the launch of network hubs in key strategic countries and a global network backbone to efficiently and reliably transmit the network traffic.

- Turning to the clearing area, we continue to expand our OTC product offering and remain well positioned to benefit from the regulatory mandate. Earlier this week, the CFTC voted to propose several classes of interest rate and credit default swaps for the clearing mandate and also finalized the rule on the phasing of the clearing mandate. The proposal on interest rate and credit default swaps marks a significant milestone for mandated clearing. Once it is published in the Federal Register, a 90-day review period will begin, with the first 30 days including a public comment period. This proposal only applies to interest rate and credit default swaps, and will be followed by energy swaps and other asset classes, which will generally follow this same process. Assuming the proposed and final rules are published in the coming weeks, our current working assumption is the clearing mandate for all or a subset of these interest rate and credit default swaps will be in effect for swap dealers and major buy-side participants in early 2013. The clearing mandate for additional market participants will be phased in over the course of 2013.

- Also, earlier this month, the CFTC passed final product definitions as well as the final rules for the end user exception to the clearing requirement for swaps. Once the long awaited product definition rules and the rules for implementing the clearing mandate are published in the Federal Register, the clock officially starts for compliance with a host of rules already passed by the CFTC. This progress in rulemaking is a key step forward for the CFTC, and clears the way for them to finalize the remaining rules.

- Several new buy-side firms cleared their first OTC swaps with CME over the last 2 weeks. We've seen a significant increase in firms finalizing their internal OTC clearing readiness, and setting up production accounts to prepare for clearing. Importantly, during the second quarter, we finalized our long-term OTC clearing agreements with the major sell-side banks for clearing both IRS and CDS. Of particular note is the global nature of the IRS clearing arrangement which enables expansion of our clearing services with this group and other potential partners into Europe and other regions around the world.

- To date, we have cleared nearly $700 billion across OTC financial products with $554 billion in IRS and $138 billion in CDS. Open Interest currently stands at $362 billion; a $52B increase since May. We remain the leader in D-to-C OTC clearing for US customers.

- Also, during the quarter, we began clearing FX OTC non-deliverable forward trades, further expanding our market leading OTC solution across multiple asset classes. We continue to work with buy-side, sell-side and clearing member firms to further develop our overall OTC offering, and FX has become a key priority for clients in the last few months.

- As we noted on the last earnings call, we started to provide portfolio margining of OTC interest rate swap positions and Eurodollar and Treasury Futures for house accounts on May 7. The risk reduction achieved will result in capital efficiencies of up to 85 percent for certain portfolios, figures that remain unparalleled in the industry. We expect the same capital benefits should be available for customer accounts prior to the mandatory clearing date.

- Shifting to our globalization efforts, we continued to make progress during the quarter. Our processing services revenue has more than doubled to $4.2 million compared to last year, the strongest quarter we have had, and up significantly from Q1. This strong growth was driven mainly by increases from BM&FBovespa, Bursa Malaysia and the Korea Exchange. In addition, looking at the breakdown of trading in CME Group's products globally, we had an 8 percent increase in Globex trading revenue during the quarter compared to Q1, with the strongest growth from Asia and South America, each up more than 20 percent. We also continue to see improved liquidity throughout the trading day, with Globex ADV during non US trading hours up 9 percent sequentially, while US trading hours ADV grew at 3 percent.

- In summary, this was another challenging quarter for the financial services sector. However, we do not let that distract us from positioning the company to build on its industry leading business by expanding our diverse product offering while continuing to invest in our global growth strategy. We will continue to remain as efficient as we can with a strong focus on expense discipline, which you saw this quarter. We continue to generate significant cash flow, and we remain committed to returning excess capital to our shareholders. We are well situated to ride out the current cyclical weakness and are focusing on positioning ourselves to fully benefit when the current headwinds turn into tailwinds.

- Now, I will turn the call over to Jamie to discuss the financials.

Jamie

- Thank you Gill and good morning everyone. Today, I am going to review the results of what has been a very productive quarter, while we also continued our focus on efficiency. We accomplished a lot during the quarter, including the sale of the CBOT Building, a smooth CEO transition, and the close of our joint venture with McGraw-Hill at the end of June. I am going to cover quite a few details which should assist with modeling going forward. Many of the activities in the quarter drove non-recurring items which are included in our GAAP results, and were noted in the earnings release. I will touch on these during my comments. In addition, we completed a 5 for 1 stock split in July, which is reflected in our results today for all periods referenced.

- Let me start with revenue – as Gill mentioned, average daily volume was down compared to the second quarter last year, however, volume trended up in the latter part of the second quarter and, in total, increased slightly from Q1. Total revenue came in at $796 million, up 3 percent from the first quarter.

- The rate per contract for the second quarter was 81.2 cents, which was up slightly from the second quarter last year and in line with the Q1 RPC. Compared to last quarter, the product mix was favorable, offset by unfavorable venue mix and higher volume discounts.

- Turning to expenses, total GAAP expense was $327 million. Excluding the non-recurring items from the quarter, operating expense would have been $306 million, down $17 million from the first quarter GAAP operating expense of $323 million. These items impacted us in the compensation, professional fees, and license fee lines.

- Starting with Compensation and Benefits, this line item was $131 million, which included $12 million of contractual payments, including costs associated with accelerated vesting of stock-based compensation, associated with Craig's retirement, and severance related to the S&P Dow Jones Indices deal, the CBOT Building sale, the Green exchange transaction and our voluntary exit incentive program. In addition, due to the 3 percent decrease in the equity market in Q2, we had a credit of $1.7 million in deferred compensation, which is offset with lower investment income, compared to $4.1 million of deferred compensation expense in the first quarter.

- Our overall headcount went down during Q2, from 2,702 to 2,604, driven by the S&P Dow Jones transaction and the sales of CMA and the CBOT Building. Another 110 employees from the S&P Dow Jones transaction will move off the CME payroll to the JV in July, bringing the total CME Group number of employees down to approximately 2,500. Lastly as mentioned in Q1, we opened an office in Northern Ireland, which is focused on certain technology functions we are augmenting overseas. Our plan is to initially hire between 80 and 90 employees there, which will allow us to develop technology capabilities in support of our European and Asian growth efforts. This addition of headcount will reduce our overall expense as these individuals will replace existing technology consultants.

- Turning to non compensation expense, there were 2 primary expense categories which were impacted by the index JV transaction. Within professional fees, we incurred approximately $6 million of success fees related to the deal. Also, within license fees, we will move to a profit sharing arrangement from a per contract fee, which we discussed when we announced the deal. Despite closing on the last day of June, we paid a retroactive incremental amount of $3 million dollars for the full impact of the second quarter profit sharing.

- Our operating margin, not including the $21M of expense adjustments, was 61.6 percent.

- Turning to non operating income, for the quarter we had a net $65 million gain related to the S&P Dow Jones transaction which is included in our GAAP results. Our tax expense on a GAAP basis totaled $257M, which includes a $132M non-cash charge for the establishment of deferred tax liabilities associated with the closing of S&P Dow Jones JV.

- Capital expenditures, net of leasehold improvement allowances, totaled $34 million in the second quarter. For 2012, our CAPEX expectations remain in the $140 to $150 million range.

- A couple final comments on modeling –

    During the second quarter, we collected approximately $27 million of revenue from the Dow, CMA and Real Estate businesses which will not continue going forward. I expect expenses in the second half of the year to drop to $595 million, from $629 million in the first half. Several expense items are back end loaded such as marketing and depreciation. In addition, based on CFTC rule making progress around the clearing mandate, our potential build out of a swap data repository, and other requirements, we expect higher regulatory and legal related costs in Q3 and Q4. For Q3, at this point I would expect expenses to be in the $300 million range. One final note, going forward we will be recognizing our share of the quarterly income from the JV in non-operating income. An early, rough estimate for this share is $15 million per quarter this year depending largely on index trading volumes and assets under management.

- Lastly, we continue to make progress on the tax front; and we are adjusting our tax guidance. For the second half of the year, we expect taxes to come in around 40.5 percent, down from our prior 41 percent guidance. A preliminary estimate for 2013 would be in the 38 to 39 percent range, down from our prior estimate of 39.5 percent, which we will update as appropriate.

- Turning to the balance sheet, we had $1.3 billion of cash and marketable securities at the end of June, an increase of $230 million from the prior quarter. $149 million of the increase is tied to the sale of the CBOT building. Keep in mind we make 2 tax payments during the second quarter vs. none in the first quarter and one payment in each of the remaining quarters. Total tax payments in Q2 totaled $325 million, and we paid out $150 million in the regular quarterly dividend in June. As of mid July, we had approximately $1.6 billion of cash and marketable securities on the balance sheet.

- In summary, we accomplished a lot this quarter; we closed the S&P/Dow JV, we sold the CBOT Building, we finalized our clearing agreements with the major OTC dealers, and we decreased our ongoing expenses. We are taking advantage of the current state of the markets to focus on positioning CME Group to capture future growth opportunities and to wring excess capital out of the business to return to our shareholders.

- With that, we'd like to open the call up for your questions. Only one question and one follow up please.

Statements in this document 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. 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; our ability to 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 over-the-counter 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; changes in government policy, including policies relating to common or directed clearing and changes as a result of legislation stemming from the implementation of the Dodd-Frank Act; the costs associated with protecting our intellectual property rights and our ability to operate our business without violating the intellectual property rights of others; our ability to generate revenue from our market data that may be reduced or eliminated by the growth of electronic trading, the state of the overall economy or declines in subscriptions; changes in our average 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 fixed income, 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 stemming from the financial crisis that began in 2008 and any other future crises; our ability to accommodate increases in trading volume and order transaction traffic without failure or degradation of 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 acquisition, investment and alliance strategy; 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 the repeal of the 60/40 tax treatment of such transactions; the unfavorable resolution of material legal proceedings and the seasonality of the futures business. More detailed information about factors that may affect our performance may be found in our filings with the Securities and Exchange Commission, including our most recent periodic reports filed on Form 10-K and Form 10-Q, which are available in the Investor Relations section of the CME Group Web site. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.