CME Group Q316 Earnings Call Prepared Remarks – October 27, 2016

John Peschier

Good morning, and thank you for joining us this morning. Gill and John will spend a few minutes discussing the results and then we'll open up the call for your questions. Terry, Bryan, Derek, Sean and Kim 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 on our Web site. Also, on the last page of our earnings release you will find a reconciliation between GAAP and Non GAAP measures.

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

Gill

- Thank you Mr. Peschier and thank you all for joining us. We have consistently talked about our focus on globalizing our business, growing our industry leading options on futures franchise, and solving challenges our customers face through a number of innovative product extensions. We made progress across all of these areas during the third quarter. Year-to-date, our volume is up 8 percent, as is our transaction revenue, while earnings per share is up more than 10 percent.

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

- We have expanded our global footprint in spite of the challenging macro environment over the last five years. This quarter, we saw volume from Europe and Asia grow in the low single digits while the US activity was flat. Energy, in particular, stood out in Asia, Latin America and Europe. We also saw noticeable outperformance in FX during third-quarter out of Europe, which is great to see.

- 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 Q3, our volume during European trading hours increased by 20 percent, while activity during Asian hours was up 7 percent. The US trading hours volume was down 1 percent, because of tough comps vis-à-vis August of last year.

- Turning to our efforts in our options franchise, we remain the leader relative to other global exchanges in terms of total options volume traded. During the third quarter, options reached the highest percentage on Globex to date with more than 57 percent, and September exceeded 60 percent. A critical focal point has been our continued investment in our functionality and technology to enable increased adoption of Globex execution for complex options spreads. We are pleased to confirm that we hit a record of 50 percent of all options spreads traded electronically in September, up from less than 20 percent in 2012.

- We continue to launch a number of exciting new product extensions. Our Ultra 10-year treasury contract reached 73 thousand contracts per day compared to 61 thousand in Q2. Open interest continues to build and the bid offer spread is getting tighter. Building on the success of our weekly equity options that expire Friday each week, we launched weekly equity options with Wednesday expirations about a month ago. Those are averaging 23,000 per day, and on one day we traded 45,000. In continuing to tailor contracts to meet specific client needs, we launched S&P 500 Total Return Index Futures and those have begun to trade in October. The other areas of focus related to the initial implementation of the uncleared margin requirements, include some cleared FX products like NDF's and Options, and potential new futures contracts primarily in interest rates, equity and FX.

- Moving on to our commodities portfolio – we had another strong quarter led by metals and energy, up 22 percent and 17 percent respectively year over year. In addition to strong volume growth, we continue to expand and diversify our global customer base across all of our commodities asset classes. We reached an all-time high this month in the number of large open interest holders in energy, while Ags and metals large open interest holders have grown in the mid-single digits and remain near peak levels. This reaffirms that global customers continue to manage their commodities market risk exposure here at CME Group.

- Our Metals business has been our fastest growing segment this year, with volumes up 29 percent to-date. Our Precious Metals business has performed extremely well despite a relatively flat volatility curve over the last year. With 74 percent of our Metal options now trading electronically, we have been able to expand our global customer base by delivering futures and options liquidity all the way through the Asian and European trading days. And in our Industrial Metals area, we continue to build on our success with our Copper business up 17 percent year-to-date, compared to LME's Copper business which is down 7 percent. We also continue to grow our Copper Open Interest, with September month end open interest up 17 percent year-on-year. We are particularly proud to have expanded our Metals business with Asian clients by 45 percent, proving that we can effectively build business despite a challenging volatility environment.

- Energy was particularly strong in Q3 average daily volume of 2.3 million contracts, which is up 17 percent. In Q3, crude was up 20 percent, natural gas rose 23 percent and refined products increased 13 percent. Our natural gas options business has been a particular area of success, with September volumes increasing 40 percent, driven by the significant growth in electronic volume. Within Natural Gas Options during third-quarter, we set records for monthly ADV, a single-day volume record, as well as record levels of options trading on Globex at 44 percent for August, up from just 15 percent a year ago. We believe that there are structural shifts taking place in both the crude and natural gas markets driven by the US now becoming the swing producer in these markets, and we are well positioned to benefit from this shift. We have seen natural gas prices around the world begin to connect, which we believe bodes well for our physically-settled Henry Hub contract over the long term. We see confirmation of global adoption of CME's benchmark Energy products in our global customer growth, with Energy business in Asia up 104 percent in September.

- Turning to financial products, and starting with Interest Rates - average daily volume in Q3 was up 2 percent, and year-to-date we are up 5 percent. At the end of the quarter, our large open interest holders were very close to an all-time high. Our total open interest in rates at the end of September of about 55 million contracts was up 15 percent, with Eurodollars up 17 percent and treasuries up 10 percent. Clearly, there is an increased focus on the front end of the yield curve and our Fedwatch tool is currently projecting a greater than 75 percent probability of a December move. Open interest in the first four quarterly Eurodollar futures contract reached 5.3 million contracts which is a four-year high. Also, it is nice to see that our year to date fed funds futures average daily volume is up 70 percent to 134,000 contracts per day. Within Treasuries, we have increased our Cash Treasury Penetration market share metric to the highest level to date and have increased by more than two percentage points since the beginning of the year to more than 80 percent.

- Over the counter swaps revenue approached $17 million in total during Q3, up from $13 million in Q2. We reached all-time volume records in our Latin America interest rate swaps in September, with $10 billion per day in Mexican Peso and $5 billion per day in Brazilian Real. In addition, we have begun to charge for interest rate swap compression services, and we've compressed over $2.2 trillion dollars since the fees have been implemented.

- Turning to Equities, compared to the same quarter a year ago, S&P 500 volatility dropped substantially with a more normal summer quarter. Our volume was down 12 percent, but compared favorably to the majority of the other equity related volumes traded elsewhere. For example, we track the notional value of the E-mini S&P futures that we trade compared to the SPDR ETF. Last year in the third quarter, the notional amount traded in our S&P futures was 7 times that of the SPDR. This year in Q3 that ratio jumped to more than 10 times higher. When you think about the all in cost to trade based on a tight bid/offer spread and deep liquidity we are considerably less expensive. Lastly, within FX, we have seen decent year over year growth in volume in September and October, and we have outperformed other FX venues. Most importantly, within FX we are pleased to see a new record number of large open interest holders in the most recent report in advance of the widely anticipated Fed meeting in December.

- In summary, through the hard work of our staff, we continue to expand our global footprint and product offerings to create opportunities for our clients and our shareholders. 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.

- Despite volatility in many asset classes being down significantly from Q3 last year, which included a particularly volatile August in 2015, we were able to come in basically flat in terms of revenue and EPS during the quarter. Volatility, by definition, does not come in smoothly when comparing periods, and I am pleased to say that our adjusted EPS through 3 quarters has grown 10 percent to $3.39 per share.

- ♦ Our adjusted operating expenses, excluding license fees, were down 1 percent compared to the third quarter of last year. Our adjusted operating margin expanded slightly from a year ago to almost 66 percent.

- ♦ Our rate per contract for the third quarter was 75 cents, down from the prior quarter. This was primarily due to a member/nonmember shift in some of the asset classes that saw lower volatility, like equities. Also, within energy, we had a surge in our lower priced natural gas options, which created a negative venue shift.

- ♦ Moving to expenses, excluding license fees and adjustments, our total expense dropped 1 percent from the prior year to $257 million, and it was down 5 percent sequentially.

- ♦ Compensation related expense dropped 2 percent compared to last year and the compensation ratio in Q3 was 15.2 percent, down slightly from a year ago.

Our non-compensation related expenses were down less than 1 percent compared to the third quarter of last year.

- Looking at the non-operating income and expense line, our ownership in the S&P Dow Jones joint venture drove $28.4 million in net earnings from unconsolidated subsidiaries, which was the highest level we have ever achieved.

- Turning to investment income, we received $2.7 million in dividends from BM&FBovespa. In addition, our investment returns, generated through the reinvestment of cash performance bonds and guaranty fund contributions, increased sequentially to $7.3 million from $5.2 million in Q2. This is a result of a higher average net return compared to the prior quarter. For Q3 this year, we had an average net return of 13 basis points.

- Taxes for the quarter ended at an adjusted 36.6 percent, which is slightly above where we guided.

- And now to the balance sheet – At the end of the third quarter, we had almost $1.6 billion in cash, restricted cash and marketable securities up approximately $260 million from the prior quarter. Earlier this month we sold down our BM&FBovespa stake to approximately 2.4 percent, and raised approximately $150 million. The brokerage costs were minimal so the vast majority of that will be included in our cash balance and available when we determine the annual variable dividend. We believe the steady return of capital has differentiated us from our peers, and we believe we are well positioned to continue to supplement our earnings growth with a healthy dividend for years to come.

- During the quarter, capital expenditures, net of leasehold improvement allowances were $23 million. The level of capital expenditures is impacted as we continue to leverage more software and infrastructure as a service, which is included in expense. I now expect CAPEX to come in a bit below $100 million for the year, driven by the shedding of our real estate assets and the recent sale of our data center.

- Last quarter, I mentioned the subscription program that we made available for our members. We continue to work with our membership as they weigh the benefits of taking advantage of the program. The take-up so far has been relatively small. We booked about $170,000 in Q3, and with recent conversions, we are approaching a run rate of $3 million per year of new revenue.
- We recently announced our 2017 pricing schedule.   In a targeted fashion, we adjusted the volume discount tiers, incentive plans and the base rates. If volume comes in exactly as it has this year, we would expect transaction fees resulting from the change to increase by 2 percent. We take a very long term view on pricing changes. Our goal is to increase volumes, which reduces the overall cost to trade on our markets as we bring in more participants and enhance liquidity. With record volumes and open interest and an expanding number of global participants, the value to our customers from transacting in our markets has never been greater.

- We remain focused on being as efficient as possible. We have been reducing the core operating costs to free up expense dollars to deploy on growth initiatives. We are currently working on our 2017 budget and will report out on our plans next quarter.

- Last quarter we adjusted our expense guidance, excluding license fees, for the second half of 2016 down to $548 million. The guidance remains unchanged as we have a normal ramp in the fourth quarter for marketing events, we anticipate launching a new retail advertising campaign that will likely impact us in Q4, and we are expecting higher pro fees based on some growth oriented projects that are underway. The guidance translates to less than 1 percent expense growth in 2016 on this basis.

- In summary, so far this year, revenue is up $169 million, and our incremental operating margin is 94 percent; without license fees that jumps to about 100 percent. 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 $1.6 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 in the queue, if you have any further questions. Thank you.

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. 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 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 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.*