

Q3'13 Earnings Call Prepared Remarks November 4, 2013

Gill

- ◆ Thank you for joining us this morning. I am going to highlight CME Group's third quarter and then turn it over to Jamie to review our financials. My focus today is about what is new and relevant during this quarter.

- ◆ We've made some good traction since our last earnings call in terms of the core business and expanding our over the counter clearing activity. Within our core futures complex, third quarter average daily volume was up 11 percent compared to the same period last year, driven primarily by continued strong growth in interest rates and metals. We drove strong growth in electronic trading volumes outside the United States in our entire business.

- ◆ For the third quarter 2013, Latin America volumes were up 23 percent, Asia volumes were up 22 percent, and in Europe, activity rose 15 percent compared to third-quarter 2012. We have been investing considerable time and effort in these regions, and I am glad to see it driving volume and revenue growth.

- ◆ In addition, we are making a concerted effort to drive growth in our options business globally. This business increased by 31 percent in third-quarter 2013 vs. last year. Both interest rate and equity options were up 54 percent, and FX options rose 32 percent. In September, our treasury options reached an all-time high of 57 percent electronically traded on CME Globex. Overall, in October, approximately 48 percent of our total options volume traded electronically, compared to 35 percent in all of 2012. Additionally, options trading from European clients jumped by more than 100 percent in Q3 to more than 100,000 contracts per day. Asia and Latin America, were each up over

70 percent. Lastly, within Natural Gas Options, our market share jumped above 70 percent in September, compared to a range of 50 to 60 percent for most of the year.

- ◆ As I mentioned, one of the main drivers of the top line growth this quarter was interest rates. Average daily volume was 5.8 million contracts per day in Q3, up 29 percent vs. Q3 2012, and OI to date through October is up more than 60 percent since the beginning of the year. All four of the major components of our rates business, Eurodollar futures and options, and treasury futures and options, were up more than 20 percent in Q3. Eurodollar options volume had particular strength, up 56 percent, with volume rebounding in the front part of the curve during September which we haven't seen in a long time. That is illustrated on slide 10 in our earnings deck.
- ◆ Turning to interest rate OTC clearing, we continue to see a dramatic increase in our cleared swaps business. Our market share in the dealer to client business has grown from 5 percent in Q1, to 14 percent in Q2, 31 percent in Q3, and 33 percent so far in Q4. We averaged \$81 billion per day in the third quarter, doubling the activity during the second-quarter 2013. So far, the fourth quarter is up 26 percent sequentially to \$102 billion.
- ◆ Now that the three waves of the Dodd-Frank clearing mandate are behind us, the market is shifting from a compliance phase to an optimization phase. This is a common theme we hear from market participants in our meetings.
- ◆ With increasing client demand for greater capital efficiencies, we now have six clearing members live with portfolio margining of cleared OTC interest rate swaps and interest rate futures, including a few who started offering this

solution to customers within the last month. In addition, product expansion has also played a key role in market share gains. During the third-quarter 2013, we launched the Singapore Dollar, which is our 17th interest rate swap currency and puts us in line with our competitor.

- ◆ Open interest within OTC is something we and market participants are monitoring closely, as we move closer to 50 percent market share. Interest rate swap OI is currently north of \$7.4 trillion, and has increased by more than \$3.2 trillion since our last earnings call. During this time, our main competitor has added about \$500 billion. We have done extremely well attracting phase 2 clients, made up primarily of asset managers, insurance companies, and GSE's, and we are pulling in more high turnover customers as well.
- ◆ The bottom line is winning the dealer-to-customer OTC business strengthens our overall franchise, and opens up avenues for core revenue growth. Although it is very difficult to quantify and is still in the early stages, we are seeing evidence that our interest rate complex is benefitting from a migration of activity from OTC into futures. Since May, we have seen a more than 20 percent growth in our interest rate complex each month when compared to the same month of the prior year. This year, we have seen a significant shift in the use of treasury futures vs. cash treasuries as evidenced by cash market penetration, which you can see on slide 13 in the accompanying deck. Our interest rate non-member percentage, which tends to be driven by the real money clients, rose nicely from Q2 to Q3, which helped the rate per contract. In addition, if you look at the CFTC commitment of traders report on our website, it shows a noticeable increase in asset manager participation within Eurodollars increasing from 11 percent of the open interest to more than 15 percent.

- ◆ Lastly, our deliverable swap futures activity continues to grow steadily. We had the strongest roll month in September. Building on that, in October, we had the strongest non-roll month to date.

- ◆ During the turbulence of October, we performed relatively well, despite the market uncertainty related to the debt ceiling and the government shutdown. During several weeks, economic data was not readily available, and in some cases the market adopted a wait-and-see approach as the situation developed. Nevertheless, we did what we do best, which is to continue to provide an avenue for our clients to manage risk and express their views. In October, our total ADV was up 12 percent, with rates up as well as equities, which benefitted from heightened volatility during an interesting month.

- ◆ I am very excited about the growth trajectory of the company and our entire employee base has done a tremendous job focusing on execution in the midst of a challenging macro backdrop and low interest rate environment.

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

Jamie

- ◆ Thank you Gill, and good morning everyone.

- ◆ Q3 was an excellent quarter in many respects. Average daily volume was up 11 percent compared to the third quarter last year, outperforming our major peers.

- ◆ Adjusted EPS came in at 75 cents, excluding FX related benefits and several tax impacts. We have seen a drop in our overall tax rate this quarter, and the benefit will be ongoing, which I'll touch on later.

- ◆ Now let's get into some of the details; starting with revenue –

- ◆ The rate per contract for the third quarter was 76.2 cents, up from 74.8 cents last quarter. The main driver was strong non-member participation during Q3, relative to Q2, particularly in interest rates and energy.

- ◆ OTC swaps revenue for the quarter was up almost \$5 million sequentially, to \$11.5 million, driven by a 100 percent jump in interest rate swap clearing activity. In addition to our success in attracting real-money clients, we have also been successful in executing our strategy to attract high-turnover clients, primarily large hedge funds, which on a sequential basis led to a contraction in the average rate per million. I want to clarify that although the rate we capture has declined due to an increase in the mix of higher turnover participants, we have been able to substantially grow the higher paying customer base as well, which includes asset managers and insurance companies. During the third quarter, the total notional amount cleared by this customer segment was up 115 percent sequentially, with revenue up 94 percent. In comparison, during the same time frame, the total notional amount cleared by the high turnover

participant base was up 138 percent and revenue was up 125 percent.

Overall, we are pleased to see IRS dealer-to-client market share jump from 5 percent in Q1 to 33 percent so far in Q4.

- ◆ Our Q3 interest rate product line revenue was up 32 percent to \$181 million, and if you add the incremental interest rate swap revenue, the total rates related revenue was up 40 percent. That is how we think about this business – the OTC clearing business is strengthening our overall interest rate franchise.
- ◆ Moving on, total third-quarter operating expense was \$314 million, which included a foreign exchange benefit of \$12 million, reversing the Q1 FX expense of the same amount. Excluding the FX benefit, as well as the other items noted in the reconciliation, expenses would have been \$325 million. As you recall, I guided to a higher expense level for the second half, and that is playing out.
- ◆ A couple different areas impacted us this quarter. The primary contributor to the sequential increase was in professional fees, which tends to have more variability than other expense lines from quarter to quarter. This was up \$7.7 million versus prior quarter due to an increase in IT and legal consulting fees, higher market studies expense, and higher public relations and brand consulting fees.
- ◆ Within the compensation line, we had \$3.2 million of deferred comp expense based on the strength of the equity market during the quarter. Keep in mind that this expense is offset 100 percent in the interest income line. Lastly, in Q3, license fees did not fall as much as would be expected from the seasonal decrease in Equity volumes, because we are now recording revenue share

expense related to our OTC business in this line item.

- ◆ Turning to non-operating income, the main thing to point out is interest expense dropped from \$39 million to \$35 million based on the pay down of \$750 million of debt in August. We expect that to increase back to \$40 million in Q4, based on the full quarter impact of the debt we took on in early September, and an increase in our clearing house line of credit. The total interest expense and borrowing costs line is expected to drop by \$30 million in 2014 to approximately \$123 million from \$153 million this year.
- ◆ We had put in place an interest rate lock in August of 2012, which generated \$128 million which is included in our current cash balance, and which also reduces the all-in accounting effective rate on our recent 30 year bond issuance by 50 basis points to 4.8 percent per year.
- ◆ With respect to taxes, excluding the FX impact and non-cash deferred tax items, as well as other prior year tax benefits, the effective tax rate was 35.6 percent this quarter.
- ◆ Turning to the balance sheet, we had almost \$1.4 billion of cash and marketable securities along with an additional \$750 million held in cash for the Feb 2014 debt pay down.
- ◆ During the third quarter, capital expenditures net of leasehold improvement allowances totaled \$36 million, bringing us to \$91 million so far this year.
- ◆ In terms of guidance, I said last quarter we expected 2013 expenses to range from \$1.25 to \$1.26 billion, and I anticipate that expenses in Q4 will be close to

\$325 million, which means we expect to be near \$1.26 billion, including \$6 million of deferred compensation expense year-to-date. In terms of CAPEX – I expect between \$130 and \$140 million for the year, which is down from my prior estimate.

- ◆ Within market data, we recently announced to clients we are expanding our fees per professional screen from \$70 per month to \$85 per month, beginning in January 2014.
- ◆ We are making very good progress in the sale of our building in New York City. Contrary to some media reports, we have not yet closed the transaction, although we are working diligently to complete it by year end. Assuming we close it, we plan to include the net proceeds in our annual variable dividend. For modeling purposes, you should know our cost basis for tax purposes is fairly low, so apply our tax rate to whatever you assume we will sell the building for to arrive at estimated cash flow. In contrast, there will likely be a loss for GAAP purposes as the building had been re-valued on our balance sheet at the time we merged with NYMEX.
- ◆ Lastly, we have made some great progress on the tax front. We had previously guided in the 38 to 39 percent range. At this point we expect 37 to 38 percent going forward in Q4 and beyond.
- ◆ In summary, we continue to focus on investing for the future; in particular, we have positioned ourselves to fully take advantage of the changing regulatory and competitive landscape as well as the medium-term favorable cyclical trends. As always, while investing in our future, we also remain intensely focused on generating excess capital and returning it to our shareholders.

- ◆ With that, we'd like to open up the call for your questions. As we have over the last few quarters, given the number of analysts who cover us, we ask that you limit yourself to one question. Please feel free to get back into the queue if you have 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 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 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, including the impact of any changes in domestic and foreign laws or government policy with respect to our industry, including 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; 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 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 stemming from the continued uncertainty in the financial markets; our ability to accommodate increases in contract volume and order transaction traffic 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 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 repeal of the 60/40 tax treatment of such transactions; the unfavorable resolution of material legal proceedings; and the seasonality of the futures business. 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.