Q3'14 Earnings Call Prepared Remarks
October 30, 2014

<u>Gill</u>

- Thank you for joining us today. I will start by talking about the highlights of the third quarter. Then, I'll provide an overview of the recent leadership reorganization and staff changes. And lastly, I will provide an observation on what we are seeing so far in the fourth quarter, before handing it over to Jamie.

- Our core business performed well during the third quarter with average daily volume of 13.5 million contracts, up 12 percent compared with third-quarter last year. In September, with a slight pickup in volatility across several asset classes, our average daily volume grew 17 percent, and five of our six product areas grew on a year-over-year basis. During most of the year, our growth has been driven primarily by our interest rates business, so it was nice to see a broadening of growth across the board.

- Our options business was outstanding during the month of September with a record 3.1 million contracts traded per day, up 29 percent from last year. This is bolstered by a record level of Options open interest in September of 52 million, up 14 percent from 2013. Also during the quarter, we achieved volume records in our weekly FX options, weekly E-mini S&P options, soybean options, and 5-Year Treasury options. Electronic options in September were up 46 percent versus the prior year. Specifically, electronic WTI options hit a record 71 percent. We are driving this outsized Options growth by innovating new products, focusing on our options technology, and executing on our distribution initiatives to expand our global customer base. Our September volume record was short-lived, as this growth trend has continued in October with average daily volume of 3.6 million options contracts per day to date, up 68 percent.

- Two other important points about Q3, which illustrate some progress in our two primary growth initiatives –

- First, our volume from clients based outside the U.S. was impressive and has been consistently performing well the last four months. Q3 electronic ADV from European clients was 2.1 million contracts, up 22 percent on a year-over-year basis, outperforming North America which rose 13 percent. In Europe we saw growth of 28 percent year-over-year in our interest rates business and 33 percent growth in equities during the quarter. For comparison purposes, our two largest European-based competitors each saw a drop in their total volumes relative to Q3 last year. One driver of the outperformance is a more dynamic environment in terms of our product set, which has drawn more hedging and speculation from European-based firms. Also, we have invested in a greater presence in London with customer facing employees. They have a lot to talk to clients about, and are making real progress.

- In Asia, our volumes rose 12 percent compared to the same quarter a year ago. Our interest rates were up 23 percent and equities rose 36 percent in Q3 from Asia, offsetting challenging global FX and metals trading volumes. Volume in Q3 approached 500,000 contracts per day, and that amount of volume is equivalent to what the leading Asian exchanges trade on a daily basis.

- Second, our OTC efforts continued to progress during the third quarter. We maintained our leadership position in open interest on the rates side at $20 trillion notional outstanding; we hit a record of almost $180 billion cleared in September; and our trade count of almost 2,500 during September was more than 50 percent higher than any month to date. This translated into stronger revenue in Q3. Within our rates franchise we recently launched bundle futures as well as options on bundle futures, and we are encouraged by our progress. We plan to launch clearing for swaptions during the first quarter of 2015, pending regulatory approval. Finally, CME Group is committed to expanding our CDS offering in order to be the #1 multi-asset class clearing house for buy-side clients. We have invested in the development of a new risk framework which provides a more holistic model of CDS portfolio risk. This new risk framework coupled with our plan to launch iTraxx indices will give us the opportunity to increase our market share in CDS clearing during 2015.

- Now, I would like to spend a few minutes describing our efforts on the expense side, an area where our team was particularly active during the last few months. First, we announced a new executive team and leadership structure in mid-September. I'll walk you through the main changes.

- Fundamentally and essentially, we reorganized the company around our client needs and focused on the best way to meet those needs. The new organization structure also brings the individual business portfolios closer to the CEO and enhances customer responsiveness.

- First, we created a Chief Commercial Officer role, filled by Bryan Durkin. He is responsible for driving short-term and long-term revenue by harnessing our product sales team, research group, product marketing, business development and our global offices. From a products perspective, Sean Tully will head up our financial products and OTC areas, along with Derek Sammann, who is in charge of commodities and options overall. These three guys and their teams will be intensely focused on providing world-class customer service, expanding on our industry-leading innovation, and enabling clients to navigate in a changed environment. To summarize these changes, this is all about driving increased multi-year revenue growth across each of our six ecosystems.

- Our second goal in the reorganization was to drive more efficiency throughout the company. That is to improve execution, agility, and speed to market in terms of our significant operational backbone. With this goal in mind, we combined technology, clearing and global operations under Kim Taylor, and we believe with this structure we will be able to streamline how we operate and reap the benefits of greater efficiency.

- In addition, Bob Zagotta will head up strategy and execution, and will be responsible for the development and execution of the company's corporate strategy. Lastly, John Pietrowicz, when he takes over for Jamie, will work side by side with this team to ensure we are also appropriately focused on delivering shareholder value as we execute our plans. We expect to improve our agility, prioritization and efficiency, and the end result will be decreased costs and improved profitability as well as earnings growth.

- Following the reorg announcement, our teams went through a thorough process of streamlining their organizations so that we could be better positioned for growth. We reduced our workforce by approximately 150 people, primarily in technology, along with the elimination of mainly administrative functions. Going forward, our leadership team is very focused on an ongoing review of how we can be even more efficient throughout our business.

- Lastly, let me make a few comments with regard to October. Within the month, we have had 2 of our top 3 trading days in our history. It is an exceptional month - even if you removed the two highest volume days, we have averaged more than 16 million contracts per day so far. A couple observations – during October we have seen strong activity across the board with all 6 product lines up, and the financial products each up more than 50 percent compared to October last year. It's a reminder that markets tend to be interconnected in terms of volumes and volatility, particularly to interest rates. That appeared to be evident on Wednesday, October 15th.

- On that day, I was very pleased with our ability to handle such a large increase in activity from a technology and clearing perspective. Our teams work hard to prepare for heightened activity and this was an excellent time to assess our readiness for volumes which were about 3 times the norm.

- If you have listened to our media campaigns over the years, you know we refer to CME Group as the place where the WORLD COMES TO MANAGE RISK.

- You might be curious about where our volume came from on October 15th, and slide 16 illustrates that. A higher percentage of our business came from outside North America than we see in a normal day. We traded 26 million contracts electronically from North America. We had near 9 million contracts traded from outside the U.S., which is pretty large compared to what our largest peers' trade on a normal day. We traded 7.4 million contracts from Europe, which is 3 ½ times the size of normal activity and 1.1 million from Asia, more than twice as much as a normal CME day in Asia.

- There is a lot of discussion within the industry about innovation, much of which we have driven throughout our history. In recent years we have referenced a number of new interest rates products we have launched since 2010. Those contracts accounted for almost 700,000 contracts on Oct. 15th. Our innovation is unparalleled and we are in a better position to innovate now, more than ever before, with the intersection of OTC and exchange-traded markets.

- And one final point - we traded more than 25 million interest rate contracts on October 15th - the highest day ever by far - and 3 and a half times our 7.2 million average daily volume in the third quarter. Additionally, the interest rate swap market that day, as measured by the aggregate dealer to customer cleared swaps business at CME Group and LCH, was below the recent run rate. This could suggest participants saw the value in turning to CME Group's liquid markets with the heightened volatility. This was referenced in a few news articles, which basically referred to CME Group as the most cost efficient way to trade due to liquidity and capital efficiency. We agree.

- Our open interest remains elevated, and as of yesterday is 104 million contracts, up from where we were on October 14th. This suggests there is heightened engagement as participants prepare for the future.

- In summary, we have worked hard to position ourselves to create significant value for shareholders when this challenging cycle turns. While the concept of a Goldilocks environment can be debated - whether markets will vary from being too hot, or too cold or just right - we intend to provide the most responsive customer service possible, with as efficient a delivery structure as possible. No matter what happens, we continue to work to be the place where the WORLD COMES TO MANAGE RISK.

- And finally, let me turn the call over to the man that has served us with distinction over the past 26 years, my business partner, Jamie, who is participating in his last earnings call here today.

<u>Jamie</u>

- Thank you Gill, and good morning everyone.

- I am very pleased with our performance this quarter; it's nice to see some signs of strength as I prepare to pass the torch to John. One of the things I've talked about a lot over the last 10 years is the significant operating leverage in our business model, and how that leverage cuts both ways depending on the tailwinds and the headwinds we are facing. Looking at the adjusted results, our revenue increased by $48 million or 7 percent compared to Q3 last year, while our expenses were down 1 percent to $318 million. The intensified expense focus I mentioned last quarter coupled with the favorable trading environment, resulted in an incremental margin above 100 percent, and I expect it to be above 100 percent next quarter. In a normal period, we are dropping roughly 80 to 90 cents of each new revenue dollar to the operating income line.

- Now I'll turn to some revenue details:

- The rate per contract for the third quarter was 72.5 cents, down from 74.9 cents last quarter. The main driver of the change was the 7 percent growth in total volume from Q2 to Q3, driven mostly by lower-price financial products. I was very pleased to see the September rolling 3-month <u>interest rate</u> RPC remain unchanged compared with August, despite volume being up 8 percent from the prior month. The FX average rate dipped down 5 percent from August to September, but you should take note of the 19 percent increase in the rolling 3-month FX volume over the same period. We saw the same thing in equities, with the rolling 3-month volumes up 8 percent from August to September, while the associated rate dropped only 1 percent.

- I was also pleased to see the volume and revenue growth from outside the U.S. We had the highest proportion ever of non-U.S. electronic volume and revenue in Q3. For the first time, the percentage of electronic trading revenue from outside of the U.S. was above 30 percent.

- OTC swaps revenue totaled $15 million, up 17 percent versus last quarter. In Q3, we captured about $132 per IRS OTC trade, and we cleared approximately 1,750 trades per day in the quarter, up significantly from prior quarters.

- Our adjusted expenses were down $10 million sequentially, and about $4 million compared to Q3 last year. The main driver was reduced professional fees and other expense. We brought some development projects to completion, saw a waning of contingent consideration expense for prior acquisitions and reduced discretionary expenses like travel as promised last quarter. Our compensation was relatively flat sequentially, despite higher stock-based compensation resulting from our annual grants in September. We should see improvement in the compensation expense line in Q4 and beyond as a result of our recent restructuring.

- Two points on the non-operating income line. Our dividend income was approximately $5 million, down from about $9.6 million in the prior quarter when we received and recorded both the Q1 and Q2 dividends from our partner in Brazil. We also recorded a dividend from our investment in the Mexican Exchange in Q2 with no dividend from them in Q3. We had a slight uptick in interest expense from the prior quarter due to clearing line of credit costs.

- Turning to taxes, the effective rate for the year has dropped to 37.3 percent on a pro forma basis from the prior 37.5 percent, so the effective tax rate for this quarter was approximately 37 percent, including a catch up adjustment for Q1 and Q2, and I expect Q4 to be approximately 37.3 percent.

- And now the balance sheet - we had approximately $1.16 billion in cash and marketable securities at the end of the quarter. In Q3, we had significant cash outflows associated with an estimated tax payment, our regular quarterly dividend and the semi-annual interest payments due on our debt securities maturing in 2023 and 2043, which we pay in Q1 and Q3 of every year.

- Lastly, during the third quarter, capital expenditures net of leasehold improvement allowances totaled $29 million, bringing us to $95 million through 3 quarters.

- I want to provide a couple of points on guidance for Q4. I expect expenses to be approximately $332 million driven by higher marketing-related expense which we talked about before, and sequentially higher license fee and bonus expenses based on the significant increase in revenue so far to start the fourth quarter, offset a bit by lower base compensation. Based on that guidance, 2014 expenses should come in at $1.3 billion, at the low end of the range we previously provided. Also, my expectation for CAPEX this year drops to $155 million, down from our prior estimate of $175 million, primarily based on timing of reconfiguring our NY space stretching into 2015.

- Lastly, on expenses – two weeks ago we reduced our workforce by 5 percent, which Gill mentioned. As a point of reference, we ended the third quarter with headcount at 2,825. We have been working on plans for several months, and we basically took a blank sheet approach to determine the best way to drive revenue higher, while reducing expense. I personally appreciate the efforts of my colleagues to make the tough decisions to better position our company for the long term and wish our colleagues who left the best of luck in the next phase of their careers.

- One last piece of guidance I want to provide is related to 2015 expenses. With pro forma expenses for 2014 expected to be $1.3 billion - based on the compensation changes, and other expense initiatives, our current estimate is that 2015 pro forma expenses will likely come in basically flat compared to 2014, at approximately $1.3 billion - and there is some variability around that based on license fees and employee bonus. That excludes the impact of adding expense related to our pending transaction with GFI Group or other potential tuck in acquisitions. We will continue to refine this estimate as we finalize our 2015 budget and John will provide you an update on the next earnings call.

- Since I mentioned our pending transaction – let me briefly comment that we are carefully assessing the current situation and filed our S-4 on October 16th. Beyond that, we will not address any questions about the transaction, as we covered it thoroughly last quarter.

- As I step away, I am highly confident in my successor, John Pietrowicz - I expect all of you to really enjoy working with him, as I have over the last 11 years. I wish you all well and have to say I have enjoyed getting to know and to work with many of you who are listening today. I believe my interactions with you over the years definitely made me a better CFO.

- Even though I am moving on to the next phase of my life by year-end, I will continue on here as a shareholder, and I am highly confident in our teams and still believe this is truly a one-of-a-kind franchise to own and I'm excited about the future of CME Group. Thank you all.

- 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 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; 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.