Interactive Brokers Group Inc (IBKR)
Q1 2010 Earnings Call
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Executives

Deborah Liston - Director of Investor Relations
Thomas Peterffy - Chairman & Chief Executive Officer
Paul Brody - Group Chief Financial Officer

Q&A Participants

Rich Repetto - Sandler O'Neill
Mac Sykes - Gabelli & Co.
Edward Ditmire – Macquarie
Niamh Alexander – KBW
Sam Hoffman - Lincoln Square
Rob Rotschow – CLSA
James Sheridan - Private Investor

Operator

Good day, everyone, and welcome to the Interactive Brokers first quarter 2010 earnings results conference call. This call is being recorded. At this time, for opening remarks and introductions, I would like to turn the call over to Ms. Deborah Liston, Director of Investor Relations. Please go head.

Deborah Liston

Thank you. Welcome, everyone, and thanks for joining us today. Just after the close of regular trading we released our first quarter financial results. We'll begin the call today with some prepared remarks on our performance that complements the material that was included in our press release and allocate the remaining time to Q&A. Our speakers are Thomas Peterffy, Chairman and CEO, and Paul Brody, Group CFO.

I'd like to remind everyone that today's discussion may include forward-looking statements. The statements represent the company's belief regarding future events that by their nature are not certain and outside the company's control. The company's actual results and financial condition may differ possibly materially from what's indicated in these forwarding-looking statements.

For a discussion of some of the risks and factors that could affect the company's future results, please see the description of risk factors in filings made with the SEC. I also direct you to read the forward-looking disclaimers in our quarterly earnings release.

With that, I'll turn the call over to Thomas Peterffy.

Thomas Peterffy

Good afternoon and thank you for joining us. As you will see with our latest results, the market dynamics that were in play during the fourth quarter have spilled into this year and we are off to a slower start than what we were hoping for.

The story of the first quarter of 2010 is not very different from that of the last quarter of 2009. This is true both for our market-making and our brokerage businesses. Our market-making business continued to suffer with diminishing volatilities while our brokerage business continued its rapid growth in customer deposits in spite of the slow and uneventful market.

I will now focus on our performance in the first quarter for each segment. We'll start with market-making.

During the quarter, the most important factors that influenced our profitability continued to move against us. In this regard not much changed from the previous quarter. Our market-making results will depend on the behavior of bid offer spreads, implied and actual volatilities, volumes and the impact of currency movements and other results as expressed in US dollars.

I am now quoting from the previous quarter's earnings call. "The lackluster results in market-making in this quarter are largely due to the story of volatilities. You may remember that we generally carry a long volatility position. This enables us to supply liquidity in both up markets and down markets as we become sellers in up markets and buyers in down markets.

You may also recall that when implied volatility shot up to above 40 and all the way up to 80 in early 2009, we have abandoned this posture as we expected these volumes to come back down and did not want to suffer the loss that driving down volatilities with a long position would generate.

As the volatilities came back down below $40, we began accumulating our customary long volatility position and by the beginning of Q4, we were at our usual position.

At this point, implied volatility stood at $26, and as the quarter unfolded, two things happened. Implied volatilities continued to come down from $26 all the way to $20 by the end of the year, and accordingly, our long option position lost value throughout the quarter.

The actual volatility, which is a measure of the actual price changes and determines our trading profits, averaged around $16, while the implied averaged $23. So while we were spending $23 to replenish our gradually expiring long volatility positions, we received only $16 worth of benefits for them. These two developments are largely to blame for our poor performance in market-making during the first quarter." End of quote.

To continue this story for the first quarter of 2010, implied volatilities continued to decrease from 20 to 16 and actual volatilities have gone even lower, averaging around $14 for the quarter. Actual volatilities were about 70% of implied, meaning that selling options was still a very profitable strategy.

In the last several weeks and months the market seems to have taken on a new behavior. The movement of prices is squeezed into very short periods of time and most of the rest of the time prices just sit there with the S&P500 index moving within a one-point range from one hour to the next.

At least this has been the case up until last Friday. It's a great market for trading desks who service customers. They can do a trade with the customer and take the next several hours to hedge themselves without worrying that the market may run away from them.

The same is true for quasi market makers who join the NBBO with very good odds for realizing the spread or at least the exchange provided maker rebate. It is largely explained by this phenomenon that according to our own data bid offer spreads on listed options continued to narrow by about 11% from the last quarter. It is also interesting to note that the PHILEX puts this number above 20%.

Spreads have been tightening throughout 2009 and into the first quarter of 2010 primarily due to contracting volatilities and increased competition from high-frequency traders who act as market makers by utilizing customer status to gain advantages over bona fide market makers. These advantages include priority of the same price and not having to pay exchange fees.

Towards the end of last year the ISE and early this year the CBOE instituted new rules for professional traders who submit more than 349 orders per day. They took away their customer priority and began to charge them exchange fees. The result was that many of these traders had gone over to the PHILEX where they retained the existing customer privileges.

Starting as of April 1st the PHILEX is following the same rule. From now on HFTs will no longer receive customer priority anywhere and they will pay the same fees as market makers. The consequences of this rule change will depend upon how effectively it will be enforced.

Now that the PHILEX has joined with the ISe and the CBOE many of these traders have gone to the NYSE Arca Exchange which is a make or take exchange. Here the taker pays $0.45 and the maker receives $0.25.

The NYSE is hoping to gain competitive advantage by showing a penny better market than the other exchanges and given best execution rules brokers do have to route there when that is the case even if they have to pay a $0.45 taker fee.

Since the exchange pays the maker $0.25 rather than charging about the same as conventional exchanges do the maker is about $0.50 or half a penny per contract better off. As a result frequently they do have a penny better quote and in a quiet market it makes sense for HFTS to post a bid and offer in the hopes of making a tick or at least to collect the $0.25 rebate.

Now that the SEC came out last week with the proposal that they would limit access fees to a maximum of $0.30, this structure may have to change in the coming months. If they have to lower the access fee to $0.30 from $0.45 then they'll be able to pay only $0.10 to the makers which may not be enough to get a better quote.

The other two SEC initiatives that may have an impact on our market-making business is the potential prohibition or modification of maker-sponsored access and the requirement to identify large traders.

Under naked sponsored access high-speed traders can buy and sell stocks and options directly on an exchange using the broker's access code with limited oversight. The concern is that the trader could either accidentally or purposefully accumulate a large position that if it went against him he may not be able to pay for or potentially the sponsoring member may not have large enough revenue resources to pay for it either.

Thus, the SEC would require the member to credit vet each of the traders' orders before submitting it to the Exchange. But that would slow down the communication with the Exchange to a level where the trades might no longer be profitable.

The other initiative is to require that each order be accompanied by a unique number that would identify the originator which order routed to an exchange when the order belongs to a large trader.

As we generally get hurt by market manipulators and other illegal practices, we are in favor of this rule, especially as it would also have exchanges to enforce the professional trader designation.

All of these developments taken together, the loss of priority, having to pay exchange fees, elimination of maker sponsored access and trader identification are all positive for our business because they will put our undeclared competitors on a more even playing field with us.

As far as global option volumes are concerned, they increased 6.8% over the fourth quarter of '09 and by 12% on the year-over-year basis. In the US, the increases were 3.9% and 8% respectively.

This, of course, ignores the ever increasing volume associated with dividend capture trades which we estimate currently constitutes about 5% of US exchange traded option volume.

From the published reports of broker dealers we can surmise that two customer trading volumes in options in fact decreased year-on-year so that the apparent increase was reduced to HFTs.

Our market share decreased to 9.94% from 10.4% globally and for the US we are at 12.98% from 13.34% in the previous quarter.

Now I would like to say a few words about the impact of currency movements. As we've explained many times before, as market makers on many different exchanges around the world, each of our transactions in a stock option or future has a currency component.

Several years ago we decided to hedge that currency component to a self-defined basket that we call the global. We keep our equity in globals. One global we defined as consisting of 55 US cents, 24 EURO cents, 10 Yen, 3 British Pence, 3 Australian cents and 4 Canadian cents.

We chose this basket to roughly reflect the relative importance of various regions to our business mix with the criteria of free convertibility and consideration of political risk. Using this basket also assures us of preserving at least some of our assets and to continue the maintenance of our business even in a hypothetical situation where certain countries or even entire regions undergo financial collapse, nationalization, repudiation of debts or other economically catastrophic events.

Due to our continuous hedging, exchange rate movements have no impact on our earnings or net worth when we account for them in globals. But when we account for them in US dollars there is an impact equal to the change in the value of the basket as expressed in US dollars.

In this past quarter the value of the global relative to US dollars fell by almost 2% for around $90 million. Not all of this is part of reported earnings. Some of it shows up as translation loss and is reported below the line. You can always estimate our translation loss or gain by taking the equity value of each of our non-US subsidiaries and translate from local currency into dollars.

Since Timber Hill Europe is the only large one, approximately 1.5 billion Swiss Francs, multiplying the Swiss Franc loss's against US dollars by 1.5 billion will give you a good approximation of our translation loss which was about $27 million for the past quarter.

In fact, if all the subsidiaries are considered, the translation loss for the first quarter was $21 million. Finally, we did have some small losses associated with corporate announcements, but they were not significant and we continue to be encouraged by the SEC's efforts to curb insider trading.

As far as the latest developments on financial reforms are concerned, as I read the proposed Senate bill it seems that OTC derivatives and especially equity derivatives that do not have industrial use will be forced onto exchanges and into a clearing house. But even if that does not happen and these trades remain OTC, there are new capital requirements associated with the resulting positions.

Firms that are regulated by the Fed, the FDIC or the comptroller of the currency get their capital requirements from them. But other firms who are not regulated by prudential regulators will have to conform to capital requirements imposed by the SEC and the CFTC.

We think that these rising capital requirements associated with equity-based and currently OTC derivatives represent a great opportunity for us. As the capital requirements increase, other firms will not be able to carry all the positions they have been carrying. The prices or markups will rise and the lower markup business will be rubbed off.

Since we know how to price these and we have plenty of excess capital to carry the positions we'll be happy to pick up this business.

Now I will turn my discussion to our brokerage segment. I'm happy to be able to tell you that the growth of our brokerage business continues unabated. Year-over-year customer accounts increased by 21% to 140,000.

Our customers' equity grew at a very impressive 74% year-over-year and 10% sequentially to a total of $16.7 billion. This remains far ahead of the growth rate published by our competitors.

The customer's equity continue to grow along with our reputation as being the best broker for sophisticated, high-volume traders that need to obtain the best execution price and pay the lowest possible costs.

I'm proud to say that we have carefully built a savvy customer base that takes advantage of our sophisticated trading software and analytics and understands that our extremely low financing rates and trading commissions have a very meaningful impact on their bottom line.

This is evidenced by the fact that year-over-year equity per client account grew over 43% to an average of $119,000 per account even though more than 60% of our customer accounts are still small, having less than $25,000.

Our customer DARTs have weathered the past year fairly well. Our cleared DARTs decreased only about 1% from the hectic pace of last year but increased 6% sequentially. Our brokerage profit margin came in at 50% for the quarter compared to 48% in the previous quarter.

Growing our global brokerage business is our primary objective. While still 85% of our client trades are executed in the United States, 52% of our brokerage commissions are generated by clients residing outside the United States with China, including Hong Kong, Canada, Germany and Australia being the most important locations followed by the UK, Holland and the rest of Continental Europe.

Due to having an internationally diversified customer base, our currency dealing platform has assumed the growing importance for our customers. We compete by providing the tightest quotes in the business. Our quotes are frequently just half a pip wide and we charge a small commission on each trade.

Now that we stream our quotes to the iPhone and Blackberry, customers and non-customers alike can compare our quotes to their bank or broker's quotes. This includes you on this conference call. Please look at our quotes. You will be amazed by how tight they are.

Our customers can open accounts with us based in their home currency and trade products all over the world no matter what currency those products are traded in. We convert the needed currencies for them so that it is entirely seamless to the customer and it is our very tight quotes that enable us to provide this service very, very inexpensively.

This past quarter we became members of the Tokyo Stock Exchange and we are working on activating the membership for executing customer trades for both Japanese and non-Japanese customers alike.

We are continuing our push towards building the global platform that financially sophisticated people all over the world know has more products at better prices than any other broker.

Now I will turn it over to our CFO, Paul Brody, who will discuss the financials.

Paul Brody

Thank you, Thomas. Welcome, everyone. Thanks for joining the call. I will review the summary of results and then we will discuss the segments before taking questions.

The challenging conditions in market-making that continued during the latter part of 2009 have, for the second consecutive quarter, weighed on our operating results. Pre-tax profits were down along with the contribution of our market-making segment to the overall results. Nonetheless, our first quarter results in market-making showed a marginal improvement from those of the fourth quarter.

In contrast, electronic brokerage continues to post strong earnings driven by a steadily increasing number of customers bringing in primarily commission revenue but also a steady rise in net interest income.

Overall operating metrics were mixed this quarter but were stolid in brokerage. Average overall daily trade volume was 907,000 trades per day, down 7% from the year ago quarter but up 2% over the fourth quarter.

Market-making trade volume was down 21% from the prior year quarter reflecting decreases across options, futures and stock. However, electronic brokerage metrics continued at a strong pace with substantial increases in the number of customer accounts and in customer equities.

Share and contract volume was up in all major product classes. Total customer DARTs were up 2% and clear customer DARTs were down less than 1%. Orders from clear customers who clear and carry their positions in cash with us and contribute more revenue remained steady at 90% of total dart.

Net revenues were $211 million, down 29% on the year ago quarter. Within that, trading gains were $81 million, down 55% from the same period in '09. Commissions and execution fees were $92 million, up 9%.

Net interest income was $22 million, up 113% from the first quarter of '09. This came primarily from electronic brokerage, which I will discuss in more detail when I review the segment. Other income was $17 million, down 22%.

Non-interest expenses were $146 million, an increase of 13% on the year ago quarter, driven by higher variable costs and compensation expenses. Our aggressive expense management has kept our other fixed costs roughly unchanged.

Within the non-interest expense category, execution and clearing expenses were $70 million, an increase of 14% from the year ago quarter. This rise in variable costs came from both market-making and brokerage as certain US options exchanges increased their fees.

Compensation expenses were $51 million, an 18% increase over the year ago quarter reflecting growth in staff count and in part the continued phase in of expenses related to our employee stock incentive plan.

At March 31st, our total headcount was 815, an increase of 7% from March 31st '09 and 2% from the year-end '09 count. We continue to expand staff at a measured pace, somewhat slower than recent years and we continue to focus on the areas of software development, trading and risk management and customer service.

As a percentage of net revenues, total non-interest expenses were 69% and out of this number execution and clearing expense accounted for 33% and compensation expense accounted for 24%.

Our fixed expenses were 36% of net revenues, which is well above our target range and a direct result of lower revenues in the quarter. However, these measures show a marginal improvement from the fourth quarter of '09.

Pre-tax income was $65 million, down 61% from the same quarter last year. For the quarter, market-making represented 8% of pre-tax income and brokerage represented 92%.

Clearly these proportions shift largely based on the performance of our market-making business. For the year ago quarter they were 72% market-making and 28% for brokerage. So while this is a reflection of the poorer results in market-making it also reveals a robust quarter in the brokerage business.

For the first quarter our overall pre-tax profit margin was 31% as compared to 56% in the first quarter of '09 and 26% in the trailing quarter. Market-making pre-tax profit margin was 7%, down from 65% in the year ago quarter. Brokerage pre-tax profit margin was 51%, up from 42% a year ago.

It is apparent that the diversification between market-making and brokerage provides us with some stability of revenue stream in addition to leveraging the same underlying technology.

Diluted earnings per share were $0.09 for the quarter as compared to $0.30 for the first quarter of '09 and $0.06 for the trailing quarter.

Turning to the balance sheet, our balance sheet remains highly liquid with low leverage. We actively manage our excess liquidity and we maintain significant borrowing facilities through the securities lending markets and with banks.

In response to the credit market environment, we continue to hold a higher level of cash on hand, which can be seen on our balance sheet. This provides us with a buffer should we need immediately available funds for any reason.

We also continue to maintain well over $1 billion in excess regulatory capital in our broker dealer companies around the world. Long-term debt to capitalization at March 31st was 4.3% and our consolidated equity capital at March 31, 2010, was $4.88 billion.

Looking at market-making, trading gains from market-making for the first quarter of 2010 were $80 million, down 55% on the year ago quarter. Net interest income for market-making was $1 million, an increase of $2 million from the roughly flat net interest of the year ago quarter.

Net revenues for market-making were $83 million, down 55% for the first quarter of '09. Despite lower trading volumes, the variable costs of execution and clearing, our largest expense category amounting to 53% of non-interest expenses increased 21% for the first quarter of '09 to $41 million.

As I mentioned earlier, certain US options exchanges increased their fees and also the first quarter of '09 included a non-recurring refund of exchange fees. Pre-tax income from market-making was $6 million, down 95% on the year ago quarter.

Turning to electronic brokerage, customer and share contract volumes were strong across all product classes, up from the year ago quarter by 23% in options, 4% in futures and 76% in stocks. The stock volume has been partly impacted by increased volume in low priced stocks traded by our brokerage customers.

Customer accounts grew by 21% over the total at March 31st '09 and by 4% in the latest quarter. Total customer DARTs were 364,000, up 2% from the first quarter of '09 and 5% sequentially. Our clear customer DARTs, which generate direct revenues for the brokerage business, were 328,000, down 1% on the year ago quarter but up 6% sequentially.

Customer equity grew to $16.7 billion, up 74% from the year ago quarter and up 10% sequentially. The source of this growth continues to be a steady inflow of new accounts and customer deposits and, to some extent, customer profit. This reflects the continuing trend of customers transferring their accounts to interactive brokers for safety and security as well as for our advanced execution services.

New software and staff who specialize in the customer onboarding process continue to achieve higher new customer funding rates. Trade volumes resulted in revenue from commissions and execution fees of $92 million, an increase of 9% from the year ago quarter and 3% sequentially.

Net interest income rose to $20 million, up 98% from the first quarter of '09. Our growing customer cash balance has more than offset the effects of low benchmark interest rates which have continued to compress the spreads earned by our brokerage unit on customer credit balances.

Average US interest rates measured by the overnight Fed funds rate were about 0.13% during the first quarter of 2010 as compared to 0.18% during the first quarter of '09. Over the same time period, our customer cash balances increased by 30% and customer margin borrowing increased by 119%. As a result, our net interest income rose to 15% of net revenues from 9% in the year ago quarter.

Net revenues from brokerage were $127 million for the quarter, up 18% from the first quarter of '09 and up 2% sequentially. As with our market-making segment, execution and clearing fees account for a large part, in this case 46%, of our non-interest expenses in brokerage.

Based on the mix of trade volumes across product and customer types, these variable costs increased to $29 million for the quarter, up 6% on the year ago quarter and 4% sequentially.

Our real-time risk management systems operated well during the quarter and there were no unusual errors or reserves for bad debt.

Pre-tax income from electronic brokerage was $64 million for the first quarter, up 42% on the year ago quarter and up 5% sequentially. We continue to believe that the fundamental factors for continuing to grow our low-cost automated brand of brokerage are in place and we are encouraged by the steady expansion of the customer base.