Interactive Brokers Group, Inc. (IBKR)
Q3 2009 Earnings Call
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Executives
Deborah Liston - Director of Investor Relations
Thomas Peterffy - Chairman and CEO
Paul Brody - Group CFO

Presentation

Operator

Good day, everyone, and welcome to the Interactive Brokers' third quarter 2009 earnings results conference call. This call is being recorded. At this time, for opening remarks and introductions, I would like to turn the conference over to Ms. Deborah Liston, Director of Investor Relations. Please go ahead.

Deborah Liston

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

At this time, I would like to remind everyone that today's discussion may include forward-looking statements. These 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 forward-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 our filings made with the SEC. I would also direct to 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

As you can see from our results, this was a challenging quarter for our global market making activities with many unhelpful dynamics working in unison. Although I would like to note that due to the vagaries of GAAP accounting concerning foreign subsidiaries, while our GAAP b-tax earnings for the quarter were only $133 million, shareholders equity during the same period increased by $184 million to $4.823 billion or $12 a share, and at the same time the publicly held shares now have a book value of $13.63.

Meanwhile, our brokerage business continues to expand at an accelerating pace with growing profit margins. I will review each segment and then Paul Brody our CFO will discuss the financials in more detail.

Beginning with market making, I will review the various drivers that impact our trading gains and how they behaved this quarter.

First, volatility:
Actual and implied volatility levels continued their retreat. The VIX is now in the very low 20s. As the VIX got below 40, we begun to reestablish our customarily long volatility position and the ratio of actual versus implied volatility has again become an important factor in our trading results.

Just to refresh, the implied volatility derives from the prices of which options trade in the market so that it determines the price we pay for the options we buy in order to be long volatility. The actual volatility is a measure of price movement of the underlying over time and is a determinant of the trading profit that we derive from this long option position. As the ratio of actual to implied volatility decreases, our trading results suffer, as it increases they improve. The ratio during the third quarter decreased to 67% which is an unusually low number, the lowest I can remember.

Volumes; global option volumes are relatively flat compared to the second quarter and fell 6% from the year ago quarter. Our market making options contract volume fell by 27% from the prior year's quarter, which brought our overall market share to 10.5% globally and 13.4% in the US.

I attribute most of our decreased market share to three factors. First, as I have said before, much of the listed option volume in the past few quarters went to low priced, high volatility financial stock in which our participation was low. As these stocks have most recently stabilized, the trading volume is becoming more evenly distributed.

Second, High Frequency Traders or HFT, as they are often called have been taking an ever larger share of the listed option volume. I will say a lot more about this shortly. Thirdly, so many of the high volume options are now quoted so tight often one penny wide that we are no longer on both sides of every market.

Bid/offer spreads:
Bid and offer spreads on option exchanges are another important driver of profits. As I discussed on the previous quarter's call, we are still witnessing a contraction of spreads though at a decreasing rate as compared to the first quarter. I also indicated that we expected to see spreads stabilize in the near term and that actually turned out to be the case.

As published data by a US option exchange indicates, spreads contracted further in the third quarter compared to the second quarter by roughly 15%. However, the trend reversed in September when spreads widened slightly by about 5%. I believe that for the time being bid offers spreads have stabilized and they are unlikely to move much further from these levels either way, until the next liquidity event, should there be one.

Competition:
Competition does not only come from traditional market markers, but also high frequency traders who act like market markers but get certain customer preferences at the exchanges which gives them definite advantages. Effective October 9, the ISE has implemented a mandatory professional trader designation rule which identifies and classifies HFT as professional traders depriving them of customer priority which they have enjoyed up to now. Although they still trade for free while market markers pay exchange fees.

I think it is important for you to understand the exchange models in order to form an opinion of how this issue is going to evolve. On all the traditional US option exchanges where more than 90% of listed option trades take place, customers pay no exchange fee and they have priority over market makers at the same price.

So the exchanges generate zero revenues when a customer trades with another customer including an HFT. As more and more HFTs came into the market and got priority over market markers, customers to market marker interaction diminished and customer to customer increased. Thus the exchange is collecting revenues in a smaller portion of the trade.

This is the reason the ISE came with the rule to reclassify HFTs as professionals. Although they will still not pay exchange fees, by being on parity with market markers instead of having priority over them, the market marker trading volume should increase and with that exchange revenues will last.

The next question is why not have them pay exchange fees just like market markers do? If you charge them exchange fees, exchange revenues will increase by those fees collected but some HFTs may trade less or stop trading entirely. To the extent that lost volume was trades with customers who will now trade with market makers, the exchange is ahead by charging fees to HFTs. To the extent that volume was with HFTs trading with market makers the exchange would lose revenues.

It seems clear to me and I'm fairly certain that the balance is well in favor of charging the fees and that in order to maximize revenues the ISE will end up charging exchange fees to HFTs for their trades, possibly at some lower level.

This brings us to the question: will the other exchanges, the CBOE and the PHLX follow the ISE with this new rule? As you know, the CBOE is preparing for an IPO and they appear to be unsure if they are better off maximizing revenues or maximizing volumes in the near-term. We think that as HFTs are being pushed from the ISE to the CBOE and the PHLX, their customer to market makers trade will diminish further, along with their revenues. That indicates to me, that you have a little choice, but to follow the ISE.

Penny Pricing:
As you know in September, the SEC approved the expansion of the NYSEs proposed pending

pilot which already covers 63 US option clauses and accounts for roughly 50% of industry volume. Expansion will extend to 300 additional issues, phased in over four quarterly increments and ultimately encompass 85% of market volume.

Options quoted in pennies typically have tighter spreads, with greater volume and participation from HFTs. It is too early to predict how this expansion will affect our business, since it will depend on how much trading volume will increase due to tighter spreads and how much of our market maker share will expand as a result of the new ISE ruling to classify HFTs as professional customers.

As spreads and dealer profits are shrinking in the exchange listed space, OTC dealers are riding higher than ever before. I'm referring to large bank trading profits. This is prompting us to evaluate the pros and cons of expanding our market making activities to include OTC products. Regulators are inching closer to requiring central clearing and higher reporting of this and tighter reporting of these products to promote greater transparency.

The proposal to bring OTC derivatives onto exchanges seems to have taken a backseat for the time being, but may gain momentum further down the road. However, we believe that introducing a central clearing mechanism is a major first step in gaining transparency. We have come to the point where the playing field is too small on the exchanges and the opportunity is on the OTC market is too big to pass up given our sizeable capital position. With net capital of about, with shareholders equity of nearly $5 billion, we are the largest non-bank broker/dealer and well positioned to enter this market. The opportunity and the need are presented by our expanding brokerage business.

First, as you know, we are already active in the OTC foreign exchange market, where we conduct hedging transactions for our proprietary brokerage customers. We are now going to expand this to OTC forex options.

Second, we have brought in a small team of corporate bond traders. Up until now corporate bond markets on the IB brokerage platform weren't as liquid as our customers would have liked. With the addition of this team, we are planning to become a more significant presence in this market.

Thirdly, our prime brokerage customers tell us that they need to be able to trade equity-based individual index and basket swaps in order to prime with us. Given the high barriers to entry due to credit and capital considerations and the lessened competition in the wake of the credit crisis, this is a very lucrative market, compared to the exchange related products.

Brokerage:
This brings us to recent development in our brokerage business, which continues to post impressive growth rates that far outpace the industry. Year-over-year, total accounts have grown 20% and customer equity has grown by an unparallel 43%. This exemplifies the fact that the growing number of sophisticated traders seek to achieve the best execution using our superior trading technology at a lowest possible trading costs.

Although as a whole, our customers are only about 50% invested, year-to-date through September 30, while the S&P had gained 17%, the average equity per customer account grew by 37%. Savvy investors who have continued to seek out the best priced broker that can make a meaningful impact on their performance, and with our expanding global presence, this effect will multiply exponentially as we enter new countries and activate our brokerage engines.

While our brokerage operating metrics continue to shine, financial results are still off slightly from the year ago quarter, when we saw record customer trading volume. People are much more cautious about trading than they were a year ago. DARTs fell 10% year-over-year. Pre-tax income is off 11% year-over-year, but it is flat with the prior quarter. Brokerage pre-tax margin has climbed to 51% from 48% in the year ago quarter.

We are extremely excited by the accelerating growth of our brokerage business as measured by customer equity. Customer equity is at 43% year-over-year and 17% over the prior quarter. Our target customer base of financial professionals understands the impact of low financing rates and lower transaction costs on their returns.

Finally, after all these years there is a buzz about IB among professional traders and investors. Finally they are beginning to believe that what we say about our brokerage platform is not just buzz words, but the advantages we give them in cost, execution quality and market access are true and very significant. Looking at the day-to-day increase in our customer's equity is the highlight of my morning routine.

To increase our penetration among financial professionals, we developed our Employee Track Program. Financial institutions must monitor their employee's personal trading activities. Working with the compliance staff of several institutions, we have developed online monitoring and periodic customized reporting capabilities. We are now in the great position where compliance personnel are helping us market our brokerage platform to our target audience, the financial professionals.

With a similar purpose in mind we developed the Interactive Brokers Order Management System, for broker/dealer trading desks. This system is now installed on five sites: Bernstein, FBR Capital Markets, GFI, Canter and a large hedge fund, and we are in conversations with other potential users.

In addition to numerous additions and upgrades to our global brokerage platform, I would like to point out two significant steps that we have taken in the past quarter.

As I am sure you have heard there has been a great deal of retention by securities regulators focused on the securities lending market with a demand for greater transparency and centralized clearing model. Quadriserv AQS platform addresses these concerns and we believe it will be a critical component of our total offering that will help fuel our prime Brokerage business. We are just in the process of completing full integration of this electronic securities lending platform into our trading and brokerage system.

Our trader workstation now displays the best borrowing and lending rates that are available in the market for each stock and our customers can now borrow or indicate their own rate at which they would borrow stock. If you want to look at this please remember that the stock loan market closes before 11:00 am. The lending side we are still working on and I expect to bring it online soon.

Transactions are cleared by OCC so that they become the counterparty to each trade the same way as in listed options or in listed single stock futures. Several other large member firms have also joined which will add liquidity to the platform which is key to its success.

Also pending acceptance by Apple we are introducing our complementary free market data service for non-customers on the iPhone. Our customers can already access more store services on the iPhone and now non-customers may also receive market data from over 80 global exchanges, charts, screening and price alert services for free.

The non-customer data is delayed from those exchanges that charge for real time market data, but it is up to the moment for other things like spot foreign exchange quotes and all price alerts. We are currently working on offering the same service for BlackBerry users.

Finally, I'd like to provide an update on our international activities. I'll reiterate that Asia presents our biggest opportunity for growth in brokerage, where we face little to no competition in terms of servicing in professional traders that seek a global platform and can benefit from best trade execution.

In Japan, although our acquisition of Moriai Securities gave us a jump start in securing exchange membership and licenses and we have just received our membership in the Osaka Exchange. We are still facing some hurdles to becoming a direct member of the Tokyo Stock Exchange.

We opened a representative office in Shanghai last month, although we are not allowed to solicit from here, but it may talk to potential customers who come there and ask the various questions.

In India, we are still working on our membership in the Bombay Stock Exchange and our licenses to provide brokerage services to non-resident Indians and foreign institutions.

We are active on the National Stock Exchange and we are servicing Indian citizens residing in India. I will now turn it over to our CFO, Paul Brody to discuss the financials.

Paul Brody

As usual I'm going to review our summary results and then we'll discuss the segments before we take questions.

Our overall operating results for the quarter as you can see were down from the third quarter of 2008. As a comparison period, the year ago quarter was a time of great market turmoil that drove record trading volumes in all product categories. In addition interest rates were nearly 2% higher than in the current quarter, which produced higher net interest income in that quarter.

Electronic brokerage remains a bright spot as we repeated the strong results of the second quarter. Market Making revenues were down sharply, but were partially offset by a decline in non-interest expense.

The variable costs of execution and clearing were lower than in the year ago quarter, reflecting both the drop in derivatives volumes and a shift in trade volume to products with lower costs or liquidity rebates. Overall operating metrics were mixed this quarter, but were solid in brokerage.

Average overall daily trade volume was 909,000 trades per day, down 7% from the year ago quarter.   Market Making trade volume was down 9% in the prior year quarter, reflecting primarily a decrease in listed options volumes for reasons that Thomas discussed earlier.

Electronic brokerage metrics were strong this quarter. The customer base continues to grow as total customer equity increased 43% to $13.4 billion. While volume was off from the near all time high of the year ago quarter total customer DARTs were down 10% and clear customer DARTs were down 9%. Volume from cleared customers who clear and carry their positions and cash with us and contribute more revenue continues to account for about 90% of total DARTs.

Net revenues were $272 million, down 45% on the year ago quarter. Trading gains were $155 million, down 57% from the same period in '08. Commissions and execution fees were $89 million, down 9%. Net interest income was $15 million, down 51% from the third quarter of '08. And other income was $13 million, up 83%, and that's primarily on a non-recurrence of the write-down in our Hambrecht investment that we took in '08.

Non-interest expenses were $138 million, a decrease of 8% on the year ago quarter driven by lower variable cost. Our aggressive expense management has kept our fixed cost fairly stable. Within the non-interest expense category, execution and clearing expenses were 70 million, a decrease of 16% from the year ago quarter. This reduction in variable cost came from both Market Making and brokerage, as volume shifted towards SOX, where exchange and clearing fees are generally lower and liquidity rebates can be higher.

Compensation expenses were 43 million, a 9% increase from the year ago quarter, reflecting growth in staff count. At September 30, our total headcount was 794, an increase of 9% from September 30 of '08 and 6% from the year end 2008 count. We continue to expand staff at a measured pace, looking to hire talented people, especially in the areas of software development, trading and risk management, and customer service.

As a percentage of net revenues, total non-interest expenses were 51% and out of this number, execution and clearing expense accounted for 26% and compensation expense accounted for 16%. Our fixed expenses were 25% of net revenues which is above our target range and obviously a direct result of lower revenues in the quarter.

Pre-tax income was $133 million, down 62% from the same quarter last year. For the quarter, Market Making represented 55% of pre-tax income and brokerage represented 45%.

This proportion shifted from 82% from Market Making and 18% from brokerage in the year ago quarter, and while this is the reflection of the poor results in Market Making, it also reveals a robust quarter in the brokerage business.

For the third quarter, our overall pre-tax profit margin was 49% as compared to 70% in the third quarter of 2008 and 58% in the trailing quarter.

Market Making pre-tax profit margin was 50%, down from 79% in the year ago quarter. Brokerage pre-tax profit margin was 51%, up from 48% a year ago and we are even with this historical high of the second quarter of '09. We continue to view this diversification of the revenue streams as a positive development in the long term growth of our business.

Diluted earnings per share were $0.20 per quarter, as compared to $0.65 for the third quarter of '08 and $0.31 for the trailing quarter.

Turning to balance sheet, the balance sheet remains highly liquid with relatively low leverage. We actively managed 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 excess regulatory capital in our broker dealer companies around the world.

Long-term debt to capitalization at September 30 was 3.7% which was down substantially from 9.1% at year end '08 and up slightly from the prior quarter. Our consolidated equity capital at September 30th '09 was $4.82 billion.

Now I will turn to the segments, beginning with Market Making. Trading gains for Market Making for the third quarter of '09 were 148 million, down 58% on the year ago quarter. Net interest income from Market Making was 1 million, a decrease of 86% on the year ago quarter, but an improvement from the 5 million net interest expense of the trailing quarter. Net revenues from Market Making were $150 million, down 58% from the third quarter of '08.

Mixed trading volumes, down in options and futures, but up in stock, led to a 10% decrease in the variable cost of execution and clearing, our largest expense category, which amounts to 57% of non-interest expenses in Market Making from the third quarter of '08 to $43 million. Pre-tax income from Market Making was $75 million, down 74% on the year ago quarter.

Turning to Electronic Brokerage, customer trade volumes were healthy, though down 5% from the outstanding level of the year ago quarter. Customer accounts grew by 20% over the total at September 30th '08 and by about 5% in the latest quarter. Total customer DARTs was 340,000 down 10% from the third quarter of '08 and 1% sequentially.

Our cleared customer DARTs which generate direct revenues for the brokerage business was 307,000, down 9% on the year ago quarter and 3% sequentially. Customer equity grew to $13.4

billion up 43% from the year ago quarter and 17% sequentially. The source of this growth continues to be a steady inflow of new accounts and customer deposits and so far in 2009, profit for customers as well.

We believe 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. In order to foster this growth, we have developed new software and staff who specialize in the customer on-boarding process and we are achieving higher new customer funding rates as a result.

Trade volumes resulted in revenue from commissions and execution fees of 89 million, a decrease of 9% from the year ago quarter and 1% sequentially. Net interest income fell to 15 million down 27% from the third quarter of ’08. Lower benchmark interest rates have continued to compress this spreads earned by our brokerage unit on customer credit balances.

Average US interest rates, measured by the overnight Federal Funds rate, were about 0.2% during the third quarter of 2009, as compared to about 2% during the third quarter of ‘08. Our net interest income, which historically we have relied upon less than other brokers do, fell to 12% of net revenues from 15% in the year ago quarter. However, this represents a slight improvement on the trailing quarter and our growing customer cash balances positioned us well for any increase in interest rates.

Net revenues from brokerage were $122 million for the quarter, down 10% from the third quarter of ‘08, but up 1% sequentially.

As with our Market Making segment, execution and clearing fees account for a large part 45% in the case of brokerage of our non-interest expenses in brokerage. Based on the mix of trade volumes across product and customer types, these variable costs decreased to 27 million for the quarter, down 27% on the year ago quarter and 1% sequentially.

Total cost of execution and clearing arises from several factors, including declining options volume from non-cleared customers, which is a lower profit margin business. The proportion of customer orders that provide liquidity which results in fee rebates on the exchanges and ECNs, and the mix of options futures and stock. In particular, we saw a sharp 86% increase over the year ago quarter in shares of stock traded by our cleared customers.

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

Pre-tax income from electronic brokerage was $62 million for the third quarter, down 3% on the year ago quarter and level with the second quarter of ‘09. We believe the fundamental factors that are continuing to grow our low cost automated brand of brokerage -- and we’re encouraged by the steady expansion of the customer base.