Interactive Brokers Group Inc. (IBKR)
Q4 2009 Earnings Call
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Executives

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

Presentation

Operator

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

Deborah Liston

Thank you. Welcome, everyone and thank you for joining us today. Just after the close of regular trading, we released our fourth quarter financial results. We'll 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-and-A. Our speakers are Thomas Peterffy, our Chairman and CEO; and Paul Brody, Group CFO.

At this time, I'd 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 is 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 Securities and Exchange Commission. I'd 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 evening and thank you for joining us. It is a great pleasure that be bid farewell to 2009, which turned out to be a very difficult year for our market making business, especially on the heels of the prior year in which we achieved record gains. Previously, I cautioned that we were unlikely to see an encore of 2008. 2009 turned out to be significantly worse than we expected.

Despite the lackluster trading gains in our market making operations this year, our electronic brokerage business exhibited exceptional growth that continues to outperform our peers. Overall for the entire company, our annual growth in pretax profits for the past five years has averaged 26% and our profit margin was 50% for 2009. Our total equity capital, built solely on retained earnings, has grown at a five year compounded annual growth rate of 22%, reaching a total of $4.9 billion at year end.

I will now focus on our performance in the fourth quarter for each segment. We will start with market making. During the quarter, the most important factors that influenced our market making profitability continued to move against us, reaching extremes just as they moved in our favor and reaching extremes in the opposite direction the year before.
The quarter we just completed was the weakest in a very long time and certainly since we went public. Our expenses slightly exceeded our income for the quarter in market making. The last such period I remember when this happened to us was 18 years ago, and I do not think that it is any more likely to happen in the future than it was in the past. I expect that, as we move into 2010, we should see ourselves somewhere in the middle in between the results of 2008 and 2009.

From quarter-to-quarter, our market making results will continue to depend on the behavior of bid offer spreads implied and actual volatilities and volume. The lackluster results in market making in this quarter are largely due to the story of volatility. 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 above 40 and all the way up to 80 in early 2009, we have abandoned this posture as we expected these values to come back down and did not want to suffer the loss that riding down volatilities with a long position would generate. As volatilities came back down below 40 we began accumulating our customary long volatility positions and by the beginning of the fourth quarter, we were at our usual positions.
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 positions lost value throughout the quarter and 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 from them. These two developments are largely to blame for our poor performance in market making during the fourth quarter. The good news is that we are now near the historical bottom, we rarely see volatilities under 14. So this is very unlikely to happen again at these levels.

Moving on to Spreads: According to data published by a U.S. options exchange, bid and offer spreads contracted by roughly 6% compared to the 3rd quarter, which was the smallest quarterly decrease of the year. We actually saw spreads expand in September and October before they reversed in November and December.

Spreads have been tightening throughout 2009 primarily due to contracting volatilities and increased competition from high frequency traders, who act as market makers but utilize their customer status to gain advantages over bona fide market makers. These advantages include priority at the same price and not having to pay exchange fees. We may be seeing an end to this trend due to new rules implemented at 2 U.S. option exchanges that are designed to measure the activity of high frequency traders.

As HFTs exceed given volume levels they are assigned professional trader designation, effectively removing the priority they currently receive. The ISE's rule went into effect in October and the CBOE's went into effect early this month. As of early January , these traders also have to pay exchange fees, just as market makers do. We expect PHLX to follow soon with similar rules. These actions will help to further level the playing field, giving us a better opportunity to recapture our market share. The fact that the exchanges must impose these rules in order to preserve their fee revenues gives us confidence that they will take their enforcement seriously.

Another recent development that may result in reducing HFT competition is the SEC's proposal to ban naked sponsored access, which currently accounts for a significant portion of market volume. Under naked access, high speed traders can buy and sell stocks and options directly on an exchange using a broker's access code with limited oversight.

Often these brokers are purposefully, thinly capitalized and if, due to a technological hick up or just a misconceived strategy a large loss were to occur, they may be unable to pay the loss. This makes all of us, with substantial deposits at the clearing houses, nervous and we are glad that the regulators are looking at measures to reduce the likelihood of such losses happening.
The proposed rule would require an arrangement called sponsored access, whereby these traders would have to route their orders through the systems of a registered broker and subject them to pre-trade checks before routing on to an exchange.

This is exactly what we at Interactive Brokers do and have always done, with all of our customer orders. The concern amongst HFT's is that these pre-trade checks would increase latency and affect the competitive edge that they previously enjoyed with unfettered access. Smaller firms may agree to the sponsored arrangements while the larger ones may apply to become regulated brokers themselves. Some will ultimately drop out of the game altogether.

All these developments taken together, the loss of priority, having to pay exchange fees and sponsored access will put our HFT competitors on an even footing with us which is a significant positive for us going forward.

As far as global option volumes are concerned:

They were relatively flat compared to the third quarter but rose 8% year over year. This of course ignores the ever increasing volume associated with dividend capture trades, that was noted by the ISE in a recent statement. From the published reports of broker dealers, we can surmise that customer trading volumes in options in fact decreased, so that the apparent increase must be due to HFTs.

This 8% increase compares with our market making options volume which declined 3% sequentially and 23% YoY. Our total market share, including market making and brokerage, came in at 10.4% globally and 13.3% in the U.S.

Another variable that impacts our trading gains is the level of M&A activity, which has been relatively low around the globe in the past year. However, in Q4, this activity jumped to over $500 billion, roughly flat with the year ago quarter but nearly 50% higher sequentially. As this activity grows, there's an increased likelihood that we may trade with others that have more information than we do.

We did have some losses associated with corporate announcements but they were not significant. We are encouraged by the SEC's renewed efforts to curb insider trading. Now, I will turn my discussion to our brokerage segment. Year over year, customer accounts increased by 21% to 134,000 at year end. Our customers' equity grew at a fantastic 71% year over year and 13% sequentially, to a total of $15.2 billion. This is far ahead of the growth rate of our competitors.

I attribute this surge in customer equity to the reputation we have built as being the best broker for sophisticated, high volume traders that need to attain 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. And this is evidenced by the fact that year over year, equity per client account grew over 40% to an average of 113 thousand dollars per account, even though nearly 60% of our customer accounts are still small, having less than 25,000 dollars.

Our customer DARTs have weathered the past year fairly well. Our DART's decreased only about 3% from last year, but increased 2% sequentially. Our typical, more sophisticated clients are quicker to recover from last year's shock and our metrics reflect that. Our brokerage profit margins came in at 48% for the year compared to 44% in 2008.

Growing our brokerage business is becoming an ever stronger focus for us. We have a huge opportunity here because we are more automated, we have a better understanding of trading and we are more globally diversified than any of our competitors. Relying on our superior strength in programming, we were able to position ourselves along a price and automated service continuum where we have no credible competitors.

We want to be the broker of choice for financial professionals all around the globe. Financial professionals need a platform that is connected to ALL the exchanges and can handle ALL tradable products and currencies. One that is inexpensive enough and smart enough to enable them to go after even smaller opportunities and leave them with a profit. We are very far along with having built such a platform and we are determined to continue building it.

I'll now turn it over to our CFO Paul Brody who will discuss the financials.

Paul Brody

Thank you, Thomas, and welcome, everyone. As usual, I will start by reviewing the summary results, and then we'll get into the segments before we take questions. While 2009 was a challenging year to say the least, the numbers show some bright spots along with the dim spots. The comparisons to the prior year make it especially clear that this past year's sub-par performance followed the most profitable year in our history.

Our net pre-tax profits of $545 million represent a return on equity of 12.4% as compared to 35% in 2008. Nevertheless, our continuing efforts to build the Brokerage business are meeting with success and this diversification has allowed us to weather the downturn in market-making profitability.

Overall operating metrics were again, mixed for the latest quarter, but quite solid in Brokerage. Average overall daily trade volume was 888,000 trades per day, down 2% from the prior quarter and down 1% for the full year versus '08. Market-making trade volume was down 34% from the prior year quarter across options, futures and stock trading.

However, electronic brokerage metrics continued at a strong pace with healthy increases in the number of customer accounts and especially in customer equity. Total customer DARTs were down 7% and cleared customer DARTs were down 9% from the year ago quarter, when those measures were at or near their all time highs. Volume from cleared customers, who clear and carry their positions and cash with us, continued to account for about 90% of total DARTs.

Net revenues were $200 million for the fourth quarter, down 53% from the year ago quarter and $1.1 billion for the full year, down 41% from the prior year. Within that trading gains were $75 million, down 75% from the same period in '08. Commissions and execution fees were $90 million, up 2%. Net interest income was $17 million, down 8% from the fourth quarter of '08, and other income was $19 million, down 25%.

Non-interest expenses were $148 million, down 8% on the year ago quarter and 7% for the full year, driven by lower variable costs and the non-recurrence of bad debt expense associated with customers, who suffered trading losses in 2008. These declines were partly offset by increases in employee compensation and in communication costs.

Our other fixed operating costs have remained fairly stable. Within the non-interest expense category, execution and clearing expenses were $72 million, a decrease of 9% from the year ago quarter. This reduction in variable costs came from the market making segment, where the noticeable drop in volume occurred.

Compensation expenses were $48 million, a 28% increase from the year ago quarter, reflecting our growth in staff count and in part the continued phase in of expenses related to our employee stock incentives plan. For the year, compensation expenses were up 11%. At December 31, out total headcount was 801 and increased at 7% from the prior year end count.

We continue to expand staff at a measured pace, though somewhat slower in the past year than in recent years. 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 74%. Out of this number, execution and clearing expense accounted for 36%, and compensation expense accounted for 24%.

Our fixed expenses were 38% of net revenues, well above our target range and the direct result of lower revenues in the quarter. Pretax income was $52 million, down 81% from the same quarter last year. For the year, pretax income was down 56% from 2008. For 2009, market making represented 59% of pretax income and brokerage represented 41%. These proportions shifted markedly from the 82% for market making and 18% for brokerage in the prior year.

For the fourth quarter, our overall pretax profit margin was 26%, as compared to 63% in the fourth quarter of ‘08. While market making showed a small pretax loss for the quarter, brokerage pretax profit margin was 49%, up from 36% a year ago. For the full year of 2009, pretax profit margins were 53% market making and 49% brokerage.

As I mentioned earlier, for the full year, we earned pretax income of $545 million on net revenues of $1.1 billion, as compared to 2008 when pretax income was $1.25 billion on net revenues of $1.85 billion. 2009 full year overall pretax profit margin was 50%, down from 68% in ‘08. Diluted earnings per share were $0.06 for the quarter as compared to $0.49 for the fourth quarter of ‘08. For the full year ‘09, diluted earnings per share were $0.87 as compared to $2.24 for ‘08.

Looking at the balance sheet, it remains highly liquid with relatively 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 the balance sheet. This provides us with a buffer should we need immediately available funds for any reason.

We also continue to maintain over $1 billion in excess regulatory capital in our broker dealer companies around the world. Long term debt to capitalization at December 31 was 4%, which was down from 9.1% at year-end 2008.Our consolidated equity capital at December 31, '09 was $4.88 billion.

Turning to the segments, we will start with market-making. Trading gains for market making for the fourth quarter of '09 were $74 million, down 74% on the year ago quarter and down 51% for the full year. Net interest from market-making was an expense of $400,000, a decrease of $11 million from the year ago quarter. Net revenues from market-making were $75 million, down 76% from the fourth quarter of '08 and down 53% for the full year.

Lower trading volumes led to a 21% decrease in the variable costs of execution and clearing, our largest expense category, accounting for 55% of non-interest expenses in market-making from the fourth quarter of '08 to $43 million. Market-making suffered a marginal pre-tax loss of $3.5 million, versus a gain of $222 million in the year ago quarter. For the full year 2009, pre-tax income from market making was $331 million, down 68% from the prior year.

Turning to Electronic Brokerage, despite the usual fourth quarter holiday period, customer trade volumes were fairly brisk, up in options and prominently in stocks, and down in futures as compared to the year ago quarter. Customer accounts grew by 21% over the total at year end 2008, and by about 5% in the latest quarter. Total customer DARTs were 346,000, down 7% under the hyperactive fourth quarter of 2008, though up 2% from the third quarter of '09.

Our cleared customer DARTs, which generates direct revenues for the Brokerage business, was $309,000, down 9% on the year ago quarter, but up 1% sequentially. The average number of DARTs per account on an annualized basis was 597, down 24% from the 2008 period and down 4% sequentially. However, as we attract larger customers, we are observing increases in the average trade sizes across stocks, options and futures. This has resulted in 13% increase in the average commission per DART to $4.36.

Customer equity grew to $15.2 billion, up a striking 71% from the fourth quarter of '08 and up 13% sequentially. The source of this growth continues to be a steady inflow of new accounts and customer deposits and to some extent customer profit. We believe this reflects the continuing trend of customers transferring their accounts to interactive brokers for safety and security, as well as our advanced execution services.

In order to foster this growth, we have developed new software and staff to specialize in the customer onboarding process, and we continue to achieve higher new customer funding rates as a result. Trade volumes drove revenue from commissions and execution fees to $90 million, an increase of 2% from the year ago quarter and about 1% sequentially. For the full year, this top line revenue was down 2% from 2008.

Net interest income increased to $17 million, up 29% from the fourth quarter of ‘08. Lower benchmark interest rates have continued to compress the spreads earned by our Brokerage unit on customer credit balances. Average U.S. interest rates, measured by the overnight fed funds rate, were approximately 12 basis points, that’s 0.12% during the fourth quarter of ‘09, as compared to 51 basis points during the fourth quarter of ‘08.

Our net interest income, which historically we have relied on less than other brokers do, rose to 14% of net revenues from 11% in the year ago quarter. Strong growth in customer cash balances has more than offset the compression in spreads, and of course positions us well for any increase in interest rates in the future.

Net revenues from brokerage were $125 million for the quarter, up 5% from the fourth quarter of 2008, and up 3% sequentially. For the full year, net revenues from brokerage were down 6% from the prior year. As with our market making segment, execution and clearing fees account for a large part, now at 44% of our non-interest expenses in Brokerage.

Driven in part by increases in stocks and options trade volume, these variable costs increased to $28 million for the quarter, up 14% on the year ago quarter and 5% sequentially. This increase was also due to higher regulatory fees, and in particular the SEC increased its transaction fee rate fivefold in April of 2009. The rate has been reduced by about half starting this month.

Once again, our real time risk management systems operated well during the quarter, and there were no unusual errors or reserves for bad debt. Pretax income from electronic brokerage was $62 million for the fourth quarter, up 43% on the year ago quarter though down about 1% sequentially. For the full year 2009, pretax income from brokerage was $231 million, up 3% over the prior year.