

Interactive Brokers Group's (IBKR)

Q2 2022 Results - Earnings Call Transcript

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Executives

Thomas Peterffy - Chairman

Milan Galik - President, CEO & Director

Paul Brody - CFO

Nancy Stuebe - Director, IR

Analysts

Craig Siegenthaler, *BofA*

Kyle Voigt, *KBW*

Rich Repetto, *Piper Sandler*

Ryan Bailey, *Goldman Sachs*

Jun Wu, *Jefferies*

Operator

Thank you for standing by, and welcome to the Interactive Brokers Group Second Quarter 2022 Earnings Call. (Operator Instructions) As a reminder, today's program may be recorded. I would now like to introduce your host for today's program, Nancy Stuebe, Director of Investor Relations. Please go ahead.

Nancy Stuebe

Good afternoon, and thank you for joining us for our second quarter 2022 earnings conference call. Once again, Thomas is on the call, but asked me to present his comments on the business.

Also joining us today are Milan Galik, our CEO, and Paul Brody, our CFO. After prepared remarks, we will have a Q&A.

As a reminder, today's call may include forward-looking statements, which represent the company's belief regarding future events, which by their nature, are not certain and are outside of the company's control. Our actual results and financial condition may differ, possibly materially, from what is indicated in these forward-looking statements. We ask that you refer to disclaimers in our press release. You should also review a description of risk factors contained in our financial reports filed with the SEC.

I will start today's call with the "bad news": in the first half of 2022, circumstances did not evolve in our favor. First, starting at the end of last year, activity diminished in Asia because of China's crackdown on large, privately-owned companies, and many of our clients from that region suffered outsized losses. Then, late in the first quarter, the impact of the war in Ukraine began to be felt on the European economy, chilling the mood of our customers in that region. Finally, early in the second quarter, the delayed response by the Fed to inflationary pressures created fears of a recession in the US, sending market prices into bear market territory.

Deficit spending in the US has limited the government's ability to respond to rising inflation with increasingly higher interest rates, as for each 1% hike, interest on US debt increases by \$300 billion as it gets refinanced, so inflation is likely to stay with us. The same difficulty in raising rates in the face of higher inflation and the same causes are also occurring in Europe.

Customer losses in their accounts in the markets were substantial. Adding to that the impact of the withdrawal of all funded accounts by Futu to their own, new clearing firm, and an introducing broker using a custodial bank while still executing with us, our customers' funds diminished by about \$80 billion over the past two quarters. In addition, our net new account openings plummeted by about 40% by the end of the quarter.

On a brighter note, now for the “good news”. It seems that many large, global financial institutions are looking at the other side of this market valley and are beginning to focus on their clients’ trading needs. These clients more and more often want to run globally diversified portfolios, heavily weighted towards US equities, no matter where they live. Satisfying that demand would necessitate the consolidation, worldwide, of their often separately- and locally-developed technology and operations. Several such institutions believe that they can get there sooner by putting their clients on IBKR’s platform now and begin working on developing the tools to serve their unique, specific client financial needs better.

IBKR has reached a positive conclusion in several such discussions. These institutions will onboard their clients gradually and separately by type and location, beginning later in the third quarter, while others will start later this year and next. These will be introducing broker accounts and thus they will add to our number of accounts. It is for this reason that, in spite of our number of net new account openings having declined by 40% by the end of the quarter, I expect this drop to be temporary as the new introducing brokers’ accounts will begin to show up. Accordingly, I still project long term account growth of 30%. Most of our technology development capacity in the near future will be devoted to building systems that make our introducing broker and worldwide RIA platform even more compelling.

With this backdrop, we are pleased with how our business performed. We ended the quarter with a record 1 million, 923 thousand accounts, a net increase of 36% from last June. We saw account growth in all client segments and all geographic regions, with particular strength – 49% and 38% – in Europe and Asia, which together represent the majority of our accounts.

As our client base grows, DARTs have risen as well. Second quarter total DARTs were strong, at over 2.1 million. While trading in the US seems to be holding steady, we began seeing some easing of trading activity in Europe and Asia due to declining markets. Commission per DART rose due to product mix, as volumes continue to be strong in futures and options, which carry a higher commission; while in equities, higher commission per DART were from more active trading in higher-priced stocks, which helped boost commissions over last year. Higher futures

commissions include very high exchange and regulatory fees, which in part explain our higher execution and clearing direct expense.

Higher DARTs and commissions per trade led to our total commission revenues rising to \$322 million, the third highest in company history, and behind only the unusually active trading periods in the first quarters of this year and last.

Options and futures volumes continue to be strong. In the second quarter, in the US, listed options volume for the industry saw average daily volume of nearly 40 million contracts, one of the highest on record, and up 8%. Interactive Brokers' options volume was even stronger, up 11%. Our futures business was even better, with our contract volumes up 46% over last year, nearly twice the 25% increase in industry volumes. As inflation can lead to higher commodities prices, investors often use commodity futures to participate, especially when there is also volatility in the markets.

Interactive Brokers has become better at offering our customers new and innovative products, while also enabling them to navigate through our many high-quality features, at ever greater efficiency, helping them to establish their own personalized work environments and tools. The superior customer experience our platform offers continues to spread by word of mouth as well as by our institutional sales team.

In uncertain markets, the quality of our capital base matters. Our capital base grew even stronger during this period, with total equity reaching \$10.6 billion this quarter. This base funds our business in countries around the world, helps us to attract larger customers, and reassures clients looking to participate in the markets.

We saw account growth, once again, in all five of the client types that we service. Individual account growth was fastest, at 44%, followed by proprietary traders at 32%, introducing brokers at 24%, financial advisors at 15%, and hedge funds at 10%.

We are always looking to find opportunities and grow our business. We continue to place enhanced focus on our marketing efforts and we have increased spending in this area from last year. We are letting investors know that Interactive Brokers pays its clients over 1.08% on their cash balances, and if the Federal Reserve raises rates by 75 basis points, then their rate will also rise by 75 basis points, to 1.83%.

We recently introduced fractional trading in European stocks, so our clients can purchase as little as \$1 of almost any US or European stock. And in the UK, you can now open a Stocks and Shares ISA. We continue to add to the functionality of our IMPACT app. We recently added the ability to offset a selection of specific carbon-emitting activities, giving clients the ability to offset their footprint and keep track in their statements, all from their IBKR account.

We still see higher inflation as a catalyst that convinces more people that holding onto their money as cash is a losing proposition. Investing in equities worldwide will be necessary to earn a return, and Interactive Brokers will be there with our innovative platform and educational materials. We aim to be the platform of choice for the best-informed, most successful investors, and we look forward to welcoming our 2 millionth customer in the next few months.

With that, I will turn the call over to our CFO, Paul Brody, who will go through the numbers for the quarter. Paul?

Paul Brody

Thanks, Nancy. Thanks, everyone, for joining the call. I will review the second quarter operating results, and then we'll open it up for questions.

Starting with our Revenue items on page 3 of the release, we recorded another strong quarter, with increases in net revenues and pretax income on an adjusted basis. With customer account growth at 36% year-over-year, we are expanding our potential for both commission and interest revenues in the future.

Commissions were strong, reaching their third-highest quarterly revenue ever at \$322 million. Options and futures volumes outpaced the second quarter of 2021, and while stock share volumes declined from last year's quarter, notional value of stock trades actually rose.

Net interest income of \$348 million reflected higher margin loan interest despite relatively unchanged balances, thanks to increases in benchmark rates, and higher interest earned on our segregated cash portfolio, as US rates have moved from an average effective rate of 7 basis points last year to 77 in this year's quarter. These gains were partially offset by higher interest we paid on customer credit balances, as we pass through rate hikes above 50 basis points to our customers on their qualified funds.

Other fees and services generated \$43 million, with market data fees of \$19 million, down 5%, and risk exposure fee revenue of \$6 million, down 14%. Options exchange liquidity payments of \$9 million were even with the prior year. Declines in IPO fees and especially in account activity fees, which were discontinued after the second quarter of 2021, reduced the total in this line item.

Other income includes gains and losses on our investments, our currency diversification strategy and principal transactions. Note that many of these non-core items are excluded in our adjusted earnings, and without these excluded items, Other income was \$4 million for the quarter.

Turning to expenses, Execution, Clearing & Distribution costs rose 43% from last year, led by strong futures volumes, which carry higher fees, lower exchange liquidity rebates and a smaller clearing fee rebate than in last year's 2nd quarter. As a percent of commission revenues, Execution & Clearing costs, which are driven by a combination of trading volume, exchange rebates and changing fee schedules, were 18% this quarter, meaning 82% of incremental commission revenue dropped to the bottom line. While this cost ratio fluctuates over time with product mix and trading volumes, the factors that tend to drive it lower over time remain in place, with exchanges offering liquidity rebates and competing on costs, which gives our SmartRouter the opportunity to improve on execution quality for our IBKR Pro clients.

Compensation & Benefits expense, while up in dollar terms for the quarter as we continued to expand hiring to support our strong growth, was 16% of our adjusted Net Revenues, consistent with its historical level. Our headcount at quarter-end was 2,780.

G&A expenses were up \$7 million versus last year on increases in advertising, legal expenses and administrative fees.

Our adjusted pretax margin was a robust 63%. Automation remains our key means of maintaining high margins, as well as continued expense control while we hire talented people and invest in the future of our business. \$32 million of income taxes reflects the sum of the operating companies' \$16 million and the public company's \$16 million.

Moving to our balance sheet on page 5 of our release. Our total assets were \$113 billion at the end of the quarter, with growth over the last year driven by increases in our segregated cash and securities, partially offset by a reduction in customer margin loans. Our consolidated equity capital was \$10.6 billion and we have no long-term debt.

In our operating data, on pages 6 and 7, our contract volumes for all customers were strong, up 11% on the year in options, and the second highest ever in futures, up 46%. Stock share volume was down significantly versus last year's active second quarter, and the drop off was largely attributable to trading in pink sheet and other very low-priced stocks. Of note, the notional value of shares traded actually increased over the prior year, reflecting a shift toward trading higher priced stocks, which tends to raise the average commission per order.

On page 7, you can see that our account growth remains robust, with over 114,000 net account adds in the quarter, and total accounts reaching 1.9 million, up 36% over the prior year. Total Customer DARTs were just under 2.2 million trades per day, down 6% from the strong prior-year quarter.

Our Cleared IBKR Pro Customers paid an average of \$2.74 Commission per Cleared Commissionable Order, up 15% from last year as our clients' volume mix included higher per order contributions from stocks and options.

Page 8 of the release presents our Net Interest Margin numbers. Total GAAP net interest income was \$348 million for the quarter, up 27% on the year-ago quarter, reflecting stronger margin loan and segregated cash interest, partially offset by higher interest expense on customer cash balances. The Federal Reserve raised interest rates twice in the quarter, by 50 basis points in early May, and by a further 75 points in June with about 2 weeks left in the quarter. The latter raise had a minor positive impact in a 12-week quarter, but of course will have a full positive impact in the third quarter. Other regions also raised rates this quarter. This group includes the UK, Canada, Australia and Hong Kong.

Margin loan interest was up 54% to \$197 million, despite average margin loan balances relatively unchanged from last year's second quarter. Higher rates, in the US and internationally, bode well for our margin interest income.

Net interest on segregated cash turned positive in the first quarter, and in the second quarter we earned \$53 million on these balances, primarily due to the two Federal Reserve rate hikes but also to our managing to short duration on invested funds. At June 30, our US portfolio duration was 45 days, so the investments roll over into new, higher, rates with a fairly short lag time.

Securities lending net interest was \$116 million, down from the \$136 million in the active year-ago quarter, although revenue opportunities on hard-to-borrow stocks trended up during the quarter. It is worth noting that, while securities lending opportunities maintained a strong pace, it is also the case that as benchmark rates rise, a greater portion of the revenue generated by lending securities is reflected in interest on Segregated Cash, because the cash collateral received is invested as segregated funds. We estimate this impact to be about \$10 million for the quarter.

Interest on Customer Credit Balances, or the interest we pay our customers, is returning to its historical norm, as higher rates in many currencies result in our paying interest as we pass through rate increases. We paid \$37 million to our customers on these balances in the second quarter.

Now, for our estimates of the impact of increases in rates. Given market expectations of more rate hikes to come, we estimate the effects of increases in the Fed Funds rate to produce additional annual net interest income as follows: at 25 bps an increase of \$57 million; at 50 bps an increase of \$115 million; at 75 bps an increase of \$172 million; and at 100 bps an increase of \$229 million.

Note that our starting point for these estimates is June 30, with the Fed Funds effective rate at 1.58%, and based on balances at that date. These estimates do not take into account any change in how we may adjust our investment strategy to take advantage of newly higher rates, or any change in our assets.

About 21% of our customer segregated cash is not in US dollars, so estimates of US rate change impacts exclude those currencies. We estimate a 25 basis point increase in all the relevant non-USD benchmark rates would produce additional annual net interest income of \$10mm, and that rising to about \$40 million at a 100 basis point rate increase.

In conclusion, we put forward another solid performance in the second quarter, reflecting our continued ability to grow our customer base, deliver on our core services to customers while continuously adding new features and products, and manage the business effectively with strong expense control.

With that, we will now open up the line for questions.

Question and Answer Session

Operator

(Operator Instructions) Our first question comes from the line of Rich Repetto of Piper Sandler.

Rich Repetto

My question is a follow-up on the prepared remarks and the account growth that you expect in the back half of the year, I guess, Thomas, could you give us some more detail on the arrangements that you have? And how will that -- will it -- will we still see the same -- how will that run through, I guess? I'm trying to figure out like we normally model close to your 30%, but if it's going to come in chunks or what do you foresee for the more detail on the account growth?

Thomas Peterffy

So as I said, the current account growth is roughly 40% below our average growth over, say, the last year. And this new type of accounts will start kicking in very, very late this quarter and then gradually more and more of them through the first quarter of next year.

Rich Repetto

So do you think that it will sort of bridge a little bit of that gap towards the...

Thomas Peterffy

What happened was that when the market collapsed in June, it was, right? Yes. So -- or late May, I don't know when that terrible day was. Since that time, the new account fundings are way down, right? And that seems to be continuing strangely. And so I can't really say what will happen with the existing type of business other than to project forward. But what is going on right now, which is a lower level of account fundings of, say, about 15% growth, and I expect these new type of

accounts to -- as I said, to begin coming in very late this quarter and then continuing and gaining speed as we go into next year.

Rich Repetto

Got it. Okay. And then my follow-up question would be, you have brought on a lot of accounts over the past 1.5 years to 2 years. And I'm just trying to -- do you see -- we see the average trades per comp down, but we also see the commission rising because the trades that I've done, there's more of a mix of futures and options. So I guess the question is, these accounts, the large number you brought in, how do you view the quality of the account? And do you expect -- do you still expect them to season and to mature and trade more actively over time? Or are they different type that's been brought on?

Thomas Peterffy

So, as you know, we have basically 5 types of accounts. And the newer individual accounts tend to be smaller, but the other accounts -- and then your introducing broker accounts tend to be smaller and less productive, but as far as hedge funds, stock traders and financial advisers are concerned, they are basically the same. So, to the extent that our growth is more pronounced among individual accounts and introducing brokers, yes, overall, the new accounts are less productive than the old ones.

Operator

(Operator Instructions) And our next question comes from the line of Daniel Fannon from Jefferies.

Jun Wu

This is actually Jun subbing in for Dan. I just wanted to ask with the recent hike in interest rates and the prospect of sort of more to come, how are you guys thinking about sort of the duration and the makeup of your investment portfolio and to kind of generate higher returns?

Thomas Peterffy

No, we are not. That's the kind of risk that we do not want to take. We will continue to invest in T-bills and repos.

Jun Wu

Understood. Okay. And then just to confirm, the sort of 21% cash that is overseas, the investment philosophy on that front is pretty consistent with the U.S. counterpart. Is that right?

Paul Brody

Yes, in particular, outside the U.S., we are more -- even more constrained to putting client money in banks. We use very large -- the largest of the international banks. But primarily, those are the only investments we're permitted to make currently.

Operator

(Operator Instructions) Our next question comes from Kyle Voigt from KBW.

Kyle Voigt

So with 79% of the cash balances in U.S. dollar, I would have expected a bit higher yield on your seg cash balances in the quarter. I just want to confirm whether there's some lag effect from rising U.S. rates, given that 45-day duration that you disclosed. Paul, if you just could confirm that or not if we're kind of yet to see some of the benefit from the 2Q rate hikes come through maybe in the third quarter?

Paul Brody

Yes, sure. I mean that is the 45-day lag, which is why we try to put it out there, so you have the proper expectation of the rollover rate. But yes, given that rates most recently increased in May and June, we have not recorded the full effect yet. And then, of course, the market is projecting

further rate increases. And so you can probably assume that our lag time will stay relatively constant.

Kyle Voigt

And just to -- maybe I'm oversimplifying it, but if you were at a zero-day duration or investing just in overnight, you mentioned average Fed funds in the U.S. was 77 basis points in the second quarter. If we assume that 79% of those cash balances were earned at 77 basis points, you get to something like a 60 basis point yield for 2Q. So it's a pretty big variance. So that entire variance between kind of the math that I just ran through, that 60 basis points in the 42, it's just that 45-day duration kind of mismatch with the math that I just ran through. Is that fair? Just want to make sure that we're kind of modeling that seg cash yield correctly on a go-forward basis.

Thomas Peterffy

Yes. But you have to include what we're paying to the customers, right? You're including that, right?

Kyle Voigt

Yes. I'm just talking about the seg cash yield specifically, so not the credit.

Thomas Peterffy

Yes. But if you look at the total balance, we also pay to customers. So that reduces the rate we earn on that.

Paul Brody

So about 20-something percent low 20s are actually fully interest rate sensitive, meaning that we fall into categories or account sizes that we don't pay interest on. So, we get the full benefit of the rate increases on that portion. Now the interest rates are sufficiently positive in the U.S., we passed through all of the additional rate increases, except on those small balance.

Kyle Voigt

Okay. And sorry if I missed an explanation on this in the prepared remarks, but just the other fees and services revenues, I think, were down in the quarter sequentially and year-over-year. So I don't know if you could provide a bit more color on that. I know there's a lot of things that go into that line like risk exposure fees and order flow income, account -- market data fees, etcetera. So just want to know if this is kind of a new run rate or whether or not we should see a bounce back heading into the third quarter?

Paul Brody

Right. So, the primary factor that went down were the account activity fees because we discontinued them mid-last year. So, you would not expect to see those. Those were \$9 million in the last year quarter and \$1 million in this quarter. That's a policy change. I don't expect that to bounce back. The other changes were quite a bit smaller, small changes in market data, small changes in exposure fees.

Kyle Voigt

But I guess the -- I think the line declined about \$10 million sequentially from \$53 million to \$43 million. And I guess that is related to -- related to more...

Paul Brody

Right. Sequentially, the largest factor was actually a drop in the exposure fees. But remember how we think about exposure fees, they're there to help us influence the customers to take less risk in specific ways. We run lots of stress tests that look at different scenarios. And when we find certain kinds of risk that we feel that the standard margin amounts/requirements may not be covering in a stress scenario, our system automatically charges exposure fees which the customer can then decide either to keep the position on and pay the exposure fees to us either on overnight position or trim the risk on the position and avoid the exposure fee. So, we're not unhappy to see the exposure fees go down because that means we're taking somewhat less risk, and that makes us more comfortable.

Kyle Voigt

Understood. And last question for me, and I'll jump back in the queue, was just really around the execution and clearing fees. They were up 8% sequentially, while your commission revenues were down 8% sequentially. Just wondering if you could elaborate a bit more on that. I know you gave some explanations in the prepared remarks, but any more color you could kind of provide there given those diverging trends on the revenue expense side?

Paul Brody

The general factors that I cited, greater proportion of futures volume, which has a higher fee base and options as well as opposed to stocks somewhat lower exchange liquidity rebates. These all combined, cause the aggregate number to not necessarily go hand-in-hand with the volume change or even the commission change. Generally speaking, the larger trends, they do go hand in hand. But from quarter-to-quarter, we see a different product mix and that can cause these sort of anomalies.

Operator

(Operator Instructions) And our next question comes from the line of Craig Siegenthaler from Bank of America.

Craig Siegenthaler

So, we had a follow-up to Rich's first question. And we're obviously not looking for any names, but can you provide any additional color on these global financial institutions, where are they and their clients based? And what exactly will they be using IBKR for?

Milan Galik

Thanks for your question. So, we have a number of larger introducing brokers that we are integrating with right now. They are of the larger size. There are 3 of them. I would not -- I would rather not tell you who they are. They have not publicized the partnership with us either. So we

just have to wait for that announcement. All I can tell you is that these are international organizations catering to clients from more than just one country.

Craig Siegenthaler

And just for my follow-up, in the month of May, you lost an omnibus introducing broker custody relationship to a trust bank. I was just wondering if you could provide perspective on this outflow. And also, how could a trust bank win that business from IBKR?

Milan Galik

So this was one large Japanese introducing broker. We have them because they realized that they concentrated too much of their business in a single custodian. They decided to diversify. I think it was a prudent step for them, looking at it from their perspective. So that is what they have done. They currently custody with a provider that is offering them the solution of the trust bank. So that's what they're going for.

Operator

(Operator Instructions) And our next question comes from the line of Ryan Bailey from Goldman Sachs.

Ryan Bailey

With some of the account growth slowdown, I was wondering if you could give us some color on the GlobalTrader side. If there's been any difference in the accounts or the uses of the GlobalTrader App? And then maybe just as my follow-up, I'll sort of put it through that. Any color on the typical account sizes or the cash balances for those types of accounts?

Milan Galik

We started marketing the GlobalTrader not that long ago. We have more than a thousand accounts. We have a lot of downloads. We would like those downloads to turn into more funded

accounts, of course, and the adoption rate is picking up. Despite the fact that it's a simple trading app that currently allows trading of stocks in cryptocurrencies, you would think that it really benefits the most of the retail clients as you can imagine. We are advertising the GlobalTrader to larger account holders in the way that we try to appeal to the fact that despite that most of the affluent investors' finances are managed by financial advisers, we believe that they should be willing to do an occasional trade themselves, and that is what we are advertising to them. That the GlobalTrader is a very simple way for them to trade quickly without contacting their financial advisers and executing the trade they want in the moment. Whether we're going to be successful with this marketing campaign and manage to attract larger accounts, I think only time will tell.

Operator

And this does conclude the question-and-answer session of today's program. I'd like to hand the program back to Nancy Stuebe for any further remarks.

Nancy Stuebe

Thank you, everyone, for participating today. As a reminder, this call will be available for replay on our website, and we will also be posting a clean version of our transcript on the site tomorrow. Thank you again, and we will talk to you next quarter-end.

Operator

This does conclude the program of today's conference. Thank you for your participation. You may now disconnect. Good day.