ITG Q211 Earnings Call

August 9, 2012

Operator

Good morning, and thank you for joining us to discuss ITG's second quarter results for 2012. My name is [XXXX], and I will be the facilitator for today's call. After the speakers' remarks, there will be a question and answer period. I will provide further instructions before we take questions. As a reminder, this session is being recorded. I would now like to turn the call over to JT Farley of ITG.

JT Farley - IR

Thank you, and good morning. In accordance with Safe Harbor regulations, I would like to advise you that any forward-looking statements we will be making this morning are subject to a series of risks and uncertainties that may cause actual results to differ materially from those statements. These forward-looking statements speak as of today, and you should not rely upon them as representing our views in the future. While we may elect to update these forward-looking statements in the future, we undertake no obligation to do so. I advise you to read about the risk factors that may affect forward-looking statements in this morning's press release, as well as in our SEC filings.

I would like to also point out that we will be referring to non-GAAP financial measures in today's presentation. Reconciliations of these non-GAAP measures to the comparable GAAP measures can be found in this morning's press release, as well as the press releases covering prior earnings periods. Press releases and the PowerPoint slides which accompany this presentation are available for download at the Investor Relations section of itg.com. Speaking this morning are ITG's CEO, Bob Gasser and our CFO, Steve Vigliotti. To start, I'd like to turn it over to Bob.

Bob Gasser - CEO, President

Thanks, JT, and thank you for joining us to discuss ITG's second quarter results. I would like to offer a brief review of the very difficult current industry conditions and our quarterly performance, discuss some of the developments within our various product areas and wrap up with brief comments on our balance sheet.

Market Conditions

To be blunt, these are extremely trying times for the brokerage industry in general, and for ITG in particular given our heavy exposure to cash equities. U.S. volumes have been weak and unfortunately we saw a similar pattern in other geographies during the second quarter. In the face of these difficulties, we remain focused on our strategic plan to capture additional market share through measured product expansion and organic development of our research capabilities, while we prudently return capital to shareholders.

The length and severity of the secular decline in institutional equity market activity is unprecedented in our history as a firm, which has made our disciplined approach to expense management all the more important. We believe our focus and the strength of our platform positions ITG well for even the most modest of cyclical upturns.

A recent Credit Suisse report has pegged real money cash equity volumes at decade lows. The financial crisis of 2008, including the failure of two major investment banks, prompted a broad deleveraging among investors. Since then, the ongoing Euro crisis and slowing growth in China have created an environment which is very difficult for global equity volumes.

In terms of the equity markets, the 2010 Flash Crash and the turbulent IPO of Facebook have prompted critics to question the fundamental integrity of the US equity markets.

I’ve said it before, but it bears repeating – our market structure is far from perfect, but it is not broken. Total trading costs for U.S. stocks have fallen more than 70% over the past decade, and we have the data to prove it. This has been made possible by advances in technology – and with those advances comes the need for increased risk controls. That need for technological safeguards was highlighted last week with Knight Capital.

ITG has a robust set of risk controls across our platform to prevent major trading errors. Among the controls is our business model – we act as an agent, not a principal, in the vast majority of our trading globally. Clients, many of whom have our real time monitoring tools, are very quick to react in the rare circumstance that our execution products are not performing to specifications. Trading errors do happen, but we are confident that we have appropriate risk management measures in place to minimize any harm to our firm – or to our clients.

Taking a look now at industry data from the second quarter, the headwinds we faced are clear. Active equity managers had another challenging quarter, as evidenced by $37 billion in domestic equity fund outflows, up sharply from $15 billion in outflows in the first quarter of this year, according to ICI. US equity volumes reflected these negative numbers with combined New York Stock Exchange and NASDAQ average daily volume down 5% year-over-year in the second quarter. ITG's average daily US volume was down 4% year-over-year in the same period.

Our POSIT crossing network continues to hold its own in this tough environment, averaging daily volume of 89.5 million shares in the U.S., up 8% from the second quarter of last year, while average block size in POSIT Alert in Q2 2012 was 31,000 shares. Our overall average U.S. capture rate was flat sequentially, but sell-side volumes accounted for 50% of total volume, up from 48% in the first quarter, muting the impact of a modest uptick in our buyside average rate per share.

Quarterly Performance

Turning now to our international operations, it was a difficult quarter all around.

- Our European revenues were down 11% versus the second quarter of 2011, due largely to weaker overall market turnover and lower levels of institutional trading activity in particular. According to BATS data of both lit and dark markets, pan-European turnover fell 15% year-over-year in the second quarter. Despite these headwinds, prudent cost control initiatives enabled us to increase pre-tax profits modestly compared to the second quarter of 2011. Our share of European dark trading was down slightly on a sequential basis to about 11%, but still up from 6 ½% in the same quarter last year. Investments we are making in our European production environment will give us more flexibility around our Liquidity Management efforts there and increased opportunities to expand our client base similar to what we've experienced in the U.S. As we noted in our last earnings call, we had some one-off portfolio rebalancing activity early in 2012 which boosted our results during the first quarter.

- In the Asia Pacific region, we continued to make market share gains. Regional market turnover dropped more than 20% versus Q2 2011 while our revenues were down just 12% in the same period. POSIT Marketplace is gaining traction in Asia Pacific, delivering average price improvements this year of 11 basis points per trade to the buyside institutions which are using it. We plan to expand POSIT Marketplace trading to new countries in the region by the end of the third quarter.

- Canada held up better than the rest of the markets, with revenues down about 2% versus the prior year, while overall Canadian volumes were down 17%. Our Canadian dark pool, Match Now, crossed approximately 3% of total Canadian market volume during the quarter.

Product Developments

- Moving on to ITG Investment Research, or ITG IR, we continue to make progress in building out our platform of data-driven, alpha generating research and integrating it with ITG's best in class global execution capabilities.
- Since our last earnings call, our new analyst Guo Cheng Gang initiated on the Chinese online gaming sector, marking our first foray into Asia Pacific research coverage.
- We also initiated coverage on Burger King, Direct TV and Dish Network.
- We made controversial, alpha-generating calls on names including Chipotle, Boyd Gaming and Progress Energy.

- And ITG IR fared very well in its debut appearance in the annual Greenwich Associates survey of US Equity Research. Our research was ranked #2 overall in Greenwich's index of U.S. research quality, beating out dozens of other firms including the entire bulge bracket. ITG IR was also cited for "Most Trusted Analysis" and "Best Analyst Service".

- We also marked our first foray into corporate access with the Northern Exposure energy conference in late June, featuring more than a dozen of Canada's leading exploration and production companies. The event was a success and, hopefully, the first of more to come. We will follow this up with a major energy conference in New York next month.

Outside of research, we continued to make improvements to our execution platform and offerings for both buy-side and sell-side clients.

  - We developed Switch Trade, a new innovation in controlling risk and improving performance in our HedgePro pair trading algorithm, available in North America, Brazil and Mexico.
  - We also launched ITG Smart Retail Router, a powerful liquidity capture tool designed specifically for retail broker-dealers. The events of the past week highlight the need for retail firms to take more direct control of their routing and client outcomes. We believe our best–in-class routing capability coupled with access to POSIT liquidity will be very appealing to retail firms.

Balance Sheet

- Moving on to our balance sheet, as you know we wrote down the entire balance of our goodwill, a non-cash charge of $274 million. While this is a substantial charge, we believe it is both a prudent and necessary step given ITG's current market valuation. Steve will have more details on the write-down in a few minutes.

- We also continued to return capital to shareholders through our stock repurchase program, buying back 450,000 shares of common stock for $4.1 million, or about 220% of our operating earnings. As a reminder, we've repurchased 7.4 million shares since the first quarter of 2010, returning over $102 million in capital to shareholders and reducing our shares outstanding, net of new issuances, by more than 12%. We maintain our commitment to repurchase shares at a level at or above the amount of our operating earnings each quarter and we are using the stock repurchases as a yardstick to measure against other potential uses of our capital.

Wrap Up

To wrap up, barring some type of market dislocation in Europe or elsewhere, we don't foresee market volume levels changing materially near-term. However, as we approach the U.S. election, we do think the equity markets could become a little bit more active, particularly if the race is close, as they could serve as a sort of *de facto* futures market on the outcome of the race.

But no matter how market conditions unfold in the coming months, we continue to position ourselves to weather these difficult operating conditions, holding the line on expenses, while selectively investing in our capabilities in order to remain competitive and to expand our addressable market.

I will dispense with the hyperbole at this point and tell you that our stock trades at a discount to tangible book value. It is backed by a solid balance sheet, and represents a leveraged bet on a recovery in global real money equity volumes.

We believe that ITG remains as well positioned as we ever have been in terms of product differentiation, ability to preserve and generate Alpha, the reliability of our service, and the breadth and geographic reach of our product offerings.

And with that background, I would like to turn it over to our CFO, Steve Vigliotti, to take you through the second quarter financial developments. Steve?

FINANCIAL OUTLOOK

Thanks Bob and good morning everyone.

A sharp decline in market-wide trading activity in the international regions in which we operate, together with a reduction in the amount of transitional trading activity we saw in the U.S. and Europe in the first quarter pushed our adjusted results lower during the second quarter.

As noted on slide 7, we generated revenues of $126.9 million during the second quarter, 7% lower than the first quarter of 2012 and 11% lower than the second quarter of 2011. On a GAAP basis, we incurred a net loss during the quarter of $6.40 per share compared to net income of $0.14 per share in the first quarter of 2012 and a net loss of $4.77 per share in the second quarter of 2011.

As Bob mentioned, we wrote down the remaining amount of goodwill on our balance sheet during the second quarter of 2012. On slide 8 we have detailed the non-operating items included in our GAAP results for the second quarter of 2012 and the second quarter of 2011. There were no non-operating items in the first quarter of this year. In addition to the initial impairment charge we recorded in the second quarter of 2011, we also incurred costs related the Ross Smith Energy acquisition and a restructuring plan. The goodwill impairment charge in the second quarter of 2012 was driven by the weak global environment for institutional equity trading volumes and the decline in industry market multiples. Please note that in accordance with accounting principles, our goodwill is analyzed at the reporting unit level, which for us is our geographic segments, and not individual products and services

or specific companies acquired. This non-cash charge had no impact on debt covenants, cash flows, or normal day-to-day business operations and puts a challenging reporting issue behind us.
For the remainder of this discussion, all references to results and costs will be on an adjusted basis, excluding these items.

On slide 9 you can see our consolidated results along with separate break downs of the results from our U.S. and International operations. On a year-over-year comparative basis, consolidated expenses were down $8.8 million reflecting lower variable transaction processing costs and the impact of our cost reduction efforts. This reduction in costs is net of additional costs from our energy research operations as the second quarter of 2011 only reflects one month of expense run-rate following the acquisition.

Our consolidated pre-tax margin was 2.9%, down from 6.2% in the first quarter, and down from 7.5% in the second quarter of last year. During the second quarter of 2012, we generated earnings of $0.01 per share in the U.S. on revenues of $81.9 million and a pre-tax margin of 1.5%. Our combined international businesses generated net income of $0.04 per share on revenues of $45.0 million and a pre-tax margin of 5.6%. Our consolidated effective tax rate for the second quarter was 49.9%, compared to 35.7% in the first quarter of 2012 and 45.2% in the second quarter of 2011. The increase in our effective tax rate reflects the impact of lower international profitability, including a wider loss in the Asia Pacific region, and the relative weighting that has in our consolidated profitability.

On slide 10 you can see that our U.S. expenses were down $500 thousand sequentially to $80.7 million, primarily reflecting lower compensation and transaction processing costs. U.S. expenses declined $6.4 million compared to $87.1 million in the second quarter of 2011, reflecting, among other items, $2.5 million of lower variable transaction processing costs and $3.7 million of lower compensation costs due to our cost reduction efforts and to lower revenues. The reduction in U.S. compensation costs was net of $1.9 million of incremental compensation costs from having a full period for our energy research operations. Our U.S. compensation expense ratio was 40.5% versus 39.7% in the first quarter of 2012 and 39.3% in the second quarter of 2011. Transaction processing cost as a percentage of revenue was 13.2%, better than the 13.6% in the first quarter of 2012 and 14.3% in the second quarter of 2011. The year-over-year improvement in trading margin is due in part to the impact of improved crossing as the result of the expansion of our liquidity management program.

On slide 11 we have provided a summary of our international results. As compared to the first quarter of 2012, revenues were down $6.8 million on weaker market-wide trading activity in all our international regions. Overall international expenses were down $4.2 million. The compensation ratio for our combined international operations decreased to 36.2% from 36.7% in the first quarter as the decline in consolidated revenues lowered incentive compensation. Combined international transaction processing costs during the quarter as a percentage of revenue were 19.6%, down from 20.7% in the first quarter due to a lower portion of Asia Pacific trading activity in countries where it costs us more to execute and settle.

On the next slide we tracked the performance of our foreign segments over the past five quarters. Regional declines in market-wide trading activity resulted in lower revenues across the board and decreases in pre-tax income in Canada and APAC on both a quarter-over-quarter and year-over-year basis.

On slide 13 we have presented our U.S. volume and rate capture statistics. Our average daily executed volume was down about 4% versus both the first quarter of 2012 and the second quarter of 2011. Our overall capture rate per share has remained steady since the fourth quarter of 2011 even with an increased portion of our volume coming from the sell-side. The percentage of our volume from sell-side clients rose to 50%, up from 48% in the first quarter and 44% in the fourth quarter. Our capture rate from buy-side clients was higher than both the first quarter and the second quarter of 2011.

We maintained our repurchase activity during the second quarter in accordance with our guidance of funding repurchases based on a premium to adjusted earnings. During the quarter we repurchased 450,000 shares for $4.1 million, or $9.16 per share, and on a year-to-date basis we have repurchased 1.3 million shares for $13.2 million, representing 180% of adjusted earnings. As we view our stock as an attractive investment at current levels, we continue to believe that share repurchases are an effective way to return capital to stockholders. We currently have 2.7 million shares available for repurchase under approved authorizations.

We ended the second quarter with $228.8 million of cash and cash equivalents on our balance sheet, up from $223.0 million at the end of the first quarter. At quarter end we had cash in excess of $40 million over and above the amount needed to support our global regulatory capital needs, net of the current amount due on long term debt and severance and other compensation liabilities.

Looking ahead to the third quarter, this morning we reported July U.S. average trading volume of 167 million shares, a decline of about 5% versus June 2012 and 9% versus July 2011, less than the drop in overall market volumes. We saw a similar mix in our volume and as a result, the average rate per share on July volumes was generally in-line with Q2.

And with that, I would like to open the call to Q&A. Operator, please open up the lines for questions.