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ITG - Q3 2015 Investment Technology Group Inc Earnings Call

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PRESENTATION

Operator

Good morning and thank you for joining us to discuss ITG's Third-Quarter 2015 Results. My name is [Casia] and I will facilitate the call today. 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 conference call over to Mr. JT Farley of ITG. Please go ahead.

JT Farley - *Investment Technology Group Inc. - Managing Director IR & Corporate Communications*

Thank you, Cassie and good morning.

In accordance with Safe Harbor regulations, I would like to advise you that the 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. During the call, we will also discuss non-GAAP financial measures, adjusted to exclude certain specified items. Reconciliations of these non-GAAP financial measures to the most comparable GAAP measures are available on our website.

Press releases and the PowerPoint slides which accompany this presentation are available for download on the Investor Relations section of ITG.com.

Speaking this morning are ITG's interim CEO, Jarrett Lilien and CFO, Steve Vigliotti. To start, I would like to turn it over to Jarrett.

Jarrett Lilien - *Investment Technology Group Inc. - Interim CEO*

Thanks, JT. And thank you all for joining the call this morning, an exciting day with a lot of news.

Let me start with some comments on our announced sale of ITG Energy Research to Warburg Pincus for $120.5 million. The deal is expected to close by the end of the year and this is a clear positive for all of ITG's stakeholders.

ITG is not standing still and instead is sharpening its business focus and looking to optimize its business and its capital. We are currently evaluating alternatives for the use of the proceeds from this transaction, including strategic initiatives and share repurchases.

ITG will also serve as the exclusive sales partner for the energy research product, enabling ITG investment research customers to continue to receive the same high quality energy research, while Warburg Pincus plans to make investments in the platform to expand and improve the offering.

Steve will walk you through some of the financial implications of the transaction, but now let me turn to our third-quarter results.

Overall, it was a busy quarter and I'm proud of what everyone at ITG has accomplished against what was a very difficult backdrop. Over the past few months, we have consistently been in front of our customers, accepting accountability for the August SEC settlement, but also focusing our attention on our quality products and our quality team. We've already begun to see some improvements in our market share and more on this in a moment.

We are also pleased that Frank Troise, a proven leader in our industry, will become our new CEO. The ITG Board completed a deliberate and thorough search inside of the timetable they committed to three months ago, and most importantly, they found the absolute best candidate for what ITG needs today. Frank will join us in January after he has fulfilled his garden leave requirements and the ITG management team and I are looking forward to welcoming him onboard and to working with him come January.

Turning back to the business, let me give you some color on the third quarter performance and the business trends over the past few weeks. August marked the low point from a business and revenue standpoint. And I'm happy to report that we've come a long way since then. At this point, I think we're about halfway through the recovery from the August trough.

Our global algos, POSIT Alert, high touch trading and portfolio trading businesses all are starting to pick up steam as a number of our clients, including many of our largest accounts, have resumed normal trading levels with us.

Throughout the quarter, business levels were virtually unchanged for our platforms and analytics groups and they actually saw margins expand during the third quarter. Our platforms business has had 20 new global product wins, including 11 new clients since August 1, and we've started facilitating US client transactions in US products in our RFQ-hub business.

Taking a closer look at our performance during the quarter, while it was clearly a challenging period across our regional businesses, it is promising that all of our regions have recently experienced a number of days where their revenues were higher than the year-to-date averages through July of 2015, or in other words, pre the August SEC announcement.

Here in the US, our average daily volume in the third quarter fell 17% compared to the prior quarter, but was up 4% compared to the third quarter of 2014. US consolidated volume was up 15% sequentially and up 29% versus a year ago.

We saw a mix shift to more sell-side trading, up to 62% of total volume versus 59% in the second quarter of 2015. In addition to the business impact of the SEC settlement, our US volumes were lower in the third quarter due to the outage at our primary CenturyLink data center on August 27.

In Asia Pacific, our daily value traded in the region during the third quarter was down 39% sequentially and down 16% year-over-year. Market-wide value traded was down 12% sequentially and up 24% versus the third quarter of 2014.

Our regional business levels declined as some global asset managers paused their trading activity with us in Asia Pacific. But I'm happy to report that a number of these global asset managers have since resumed normal business with ITG and so fourth-quarter trends are looking better.

In Europe, our trading activity was steadier due to increased activity by sell-side clients with third-quarter value traded up 26% year-over-year in local currency terms, about on par with market-wide pan-European value traded as measured by BATS. Average daily value traded in POSIT was up 21% versus the third quarter of 2014 and we hit a new daily record for European value traded on August 24.

In local currency terms, commission revenue in Canada were flat as compared to the third quarter of 2014, while market-wide volumes were up 10% as growth in volume traded was offset by a lower rate from an increased sell-side mix.

Our Canadian dark pool, MATCH Now, saw its market share increase to a new record high representing about 5.5% of total trading in that market, single counted.

While our near-term focus has been on renewing customer confidence, we've continued to look for innovative ways to serve our clients and we've received some recognition for our efforts. During the third quarter, we launched a new version of our best market server algorithm for US Canadian inter-listed stocks. We published new research on lessons from recent market volatility and on improvements in view up algorithm design. And we developed a guide to the coming research on bundling rules in Europe.

On the recognition front, Waters Magazine again highlighted ITG transaction cost analysis as the best offering available in the market, while the trade cited our Triton execution management system six times in its EMS roll of honor. Awards such as these are good reminders of the value ITG has delivered to its clients consistently over its nearly three decade history and the enduring relationships we have built across the industry.

Armed with some of the most innovative products in the industry and a dedicated team of talented people who are among the best in the business, including our newly appointed CEO Frank Troise, I have every confidence that better days lie ahead for ITG and for all of our stakeholders.

And with that, I'd like to turn it over to Steve.

Steve Vigliotti - *Investment Technology Group Inc. - CFO*

Good morning, everyone. As Jarrett noted, the SEC settlement had a significant impact on our third-quarter results, although we're seeing signs of improvement in the early part of the fourth quarter.

As noted on Slide 6, we generated consolidated revenues of $120.4 million during the quarter, down 14% from the second quarter of 2015 and down 11% from the third quarter of 2014.

On a GAAP basis, we generated net income during the quarter of $0.08 per share compared to a net loss of $0.30 per share in the second quarter of 2015 and net income of $0.32 per share in the third quarter of 2014.

On Slide 7, we have detailed the non-operating items included in our GAAP results for the third quarter and the second quarter of 2015. In the third quarter of 2015, we incurred legal and professional fees related to the SEC settlement, totaling almost $2.6 million pre-tax and $1.5 million after tax or $0.04 per share.

During the second quarter of 2015, we established a reserve for the SEC settlement of $20.3 million and incurred related costs of $2.3 million, totaling $22.6 million pre-tax and $21.6 million after taxes or $0.62 per share.

Excluding these charges, adjusted net income for the third quarter of 2015 was $0.12 per share and adjusted net income for the second quarter of 2015 was $0.32 per share.

For the remainder of this discussion, all references to results and costs will be on an adjusted basis, excluding these items.

Both GAAP net income and adjusted net income in the third quarter of 2015 included a net reduction to compensation expense related to the reversal of stock and cash compensation associated with the management changes announced in August, totaling $2.1 million pre-tax and $1.2 million after tax or $0.03 per share.

There were no non-operating items in the third quarter of 2014, however, there was a net tax benefit of $2.4 million or $0.07 per share from resolving a multi-year tax contingency in the US.

Slide 8 presents our consolidated results along with separate break downs of the results from our North American and Europe and Asia Pacific operations, as well as our corporate activity.

As a reminder, corporate activity includes investment income as well as cost not associated with operating ITG's regional and product group business lines, including, among others, the cost of being a public company, intangible asset amortization, interest expense, the cost of maintaining a global transfer pricing structure, and foreign exchange gains or losses.

On a year-over-year comparative basis, consolidated revenues were down $14.4 million, while consolidated expenses were down $8 million. Our consolidated pre-tax margin was 4.8% down from 9.7% in the second quarter of 2015 and down from 9% in the third quarter of 2014.

Our consolidated effective tax rate was 27.2% for the quarter, reflecting the regional mix of our earnings. Our North American effective tax rate was 44% and our European and Asia Pacific effective tax rate was 19%.

Our North American businesses posted earnings of $0.07 per share in the third quarter on revenues of $80.9 million and our combined European and Asia Pacific businesses posted net income of $0.11 per share in the third quarter on revenues of $39.3 million.

Corporate activity lowered net income by $0.06 per share in the third quarter, an improvement compared to both the second quarter of 2015 and the third quarter of 2014 due to the impact of the $2.1 million compensation reversal discussed earlier.

On Slide 9, you can see the impact of translating the third quarter 2015 income statements of our foreign subsidiaries to US dollars using current exchange rates as compared to exchanges rates in effect in the third quarter of 2014. Current exchange rates lowered consolidated net income by $1.3 million as compared to exchange rates in effect in the third quarter of 2014. You can also see the larger impact on gross revenues and expenses.

There was no material change to earnings using current exchange rates as compared to exchange rates in effect in the second quarter of 2015.

On Slide 10, we break down the performance of our North American operations between the US and Canada. During the third quarter of 2015, we generated revenues of $66 million with a pre-tax margin of 1.1% in the US. This compares to $75.5 million of revenues with a pre-tax margin of 7.6% in the second quarter of 2015 and $72.3 million of revenues with a pre-tax margin of 8.5% in the third quarter of 2014.

Commission revenues reflect the impact of a lower average revenue per share, due primarily to the higher proportion of volume from sell-side clients following the preliminary announcement of the SEC settlement in late July.

Other revenues in the US were $1.4 million up from $1.2 million in the second quarter of 2015 and down from $3.2 million in the third quarter of 2014. The decline in other revenues as compared to the third quarter of 2014 reflects a reduction in transaction advisory services revenue.

Our US expenses fell 1% from the third quarter of 2014 due chiefly to lower telecom and data processing costs and slightly lower compensation expenses offset by higher transaction processing costs.

Our compensation ratio was 46.8% in the third quarter of 2015 as compared to 43.6% in the second quarter of 2015 and 43.1% in the third quarter of 2014. The higher rate in the third quarter of 2015 primarily reflected the impact of the revenue drop off after the SEC settlement announcement.

While commission revenues in Canada were down compared to the second quarter from the impact of the SEC settlement announcement, the decline from the third quarter of 2014 reflected the impact of currency translation. Net income for the Canadian region was reduced by $700,000 for currency translation when comparing the current exchange rates to the rates in effect during the third quarter of 2014.

Our Canadian results also reflected the impact of market-to-market adjustments on cash settle stock awards to our employees from the decline in our stock price, which reduced compensation expense by $1 million and lower compensation expense related to the reversal of stock and cash compensation associated with an executive departure during the third quarter.

On Slide 11, we break down the results of our European and Asia Pacific businesses. Results in both regions were impacted by the fallout from the SEC settlement as well as headwinds from foreign exchange translation.

European revenues were down 9% over the third quarter of last year. Our European margin declined to 16.7% reflecting a higher mix of sell-side trading. Asia Pacific revenues were down 17% compared to the third quarter of 2014 pushing the region to a net loss for the quarter of $400,000.

On Slide 12, we offer supplementary information for the last five quarters on revenues broken out by our four product groups and for investment income which we categorize as corporate. As you can see from this table, revenues in the electronic brokerage and research sales and trading groups declined on both a sequential and year-over-year basis, but revenues of both the platforms and analytics groups were generally steady.

On Slide 13, we present supplementary pre-tax information for our four product groups and for our corporate activity for the third quarter of 2015. Electronic brokerage and research sales and trading saw their margin compress, while margins actually increased for our platforms and analytics groups.

On Slide 14, we have presented our US volume and rate capture statistics. Our average daily executed volume was down 17% versus the second quarter of 2015 and up 4% versus the third quarter of 2014.

As you can see on the slide, our average overall revenue capture rate per share fell on a sequential basis to 40 mils due in large part to an increase in the proportion of trading activity from sell-side clients.

We ended the third quarter with $166.6 million of cash and cash equivalents on our balance sheet, down from $211.8 million at the end of the second quarter, due primarily to the payment of the SEC settlement, reduced cash held for soft dollar credits, and an increase in cash required for settlement activities, primarily in Europe.

Nearly half of the roughly $10 million decline in soft dollar payables from June was restored during the month of October. Our excess cash on September 30, 2015, over and above what we need for regulatory capital and compensation liabilities, was approximately $15 million, down from $20 million at June 30, 2015.

After the conclusion of the SEC settlement in August, we were active with our repurchase program and bought back 460,000 shares during the quarter for $7.2 million at an average cost of $15.58 per share.

Since the beginning of 2010, our buy backs have reduced shares outstanding, net of issuances, by more than 23%. And as you can see in today's announcement, we declared our third quarterly dividend. On a year-to-date basis, we have returned $36.4 million to stockholders in the form of share buy backs and cash dividends which is $7.2 million in excess of our year-to-date free cash flow.

We are not changing our 2015 capital return guidance at this time. Although, we will monitor our ongoing business levels and make you aware if there are any changes to our guidance going forward.

In connection with the SEC settlement, two shareholder lawsuits have been filed against ITG and certain current and former executives seeking unspecified damages. Separately, ITG's former CEO has filed a demand for arbitration claiming that his termination for cause represents a breach of his employment contract. This arbitration demand seeks an award of damages in equity totally approximately $8 million plus an additional $5 million in punitive damages.

The Company intends to defend itself vigorously in all of these matters and we have not set aside any reserves in connection with these matters.

Looking forward, I would like to offer the following observation. Starting in 2016, ITG's Board will discuss the dividend at its regularly scheduled quarterly meetings and we will issue announcements about our dividend payments and relevant dates separately from our quarterly earnings releases.

In the fourth quarter of 2015, our compensation expense, as a percentage of revenue, is likely to increase from the level of the third quarter of 2015 since the third quarter included adjustments to reverse compensation expense in the US and Canada and to mark down the value of stock [boards] that will be cash settled. We also need to maintain competitive compensation levels in order to retain our staff during this challenging period.

Our US average daily volume for October was approximately 122 million shares, which included higher levels towards the end of the month. The rate capture average on that volume was more than 10% higher than our third quarter 2015 average due to an increase in the percentage of volume trading from buy-side clients.

The average daily commissions in October in our Canadian, European and Asia Pacific business increased a combined 2% compared to the full third quarter and a combined 20% over the average from August and September following the announcement of the SEC settlement.

Upon completion of the sale of ITG Energy Research set for late Q4 2015, we expect to book an after tax gain of between $90 million and $95 million. This transaction is expected to increase ITG's tangible book value by between $2.85 a share and $3.00 per share.

Pursuant to a distribution agreement, ITG will continue to provide the energy research to institutional clients on an exclusive basis and we will earn a share of the research revenues from those clients.

On a standalone basis, energy research represents approximately $30 million of revenues at a profit margin above 40%, after taking into account fees under the distribution arrangement.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions).

Richard Repetto, Sandler O'Neill & Partners.

Richard Repetto - *Sandler O'Neill & Partners - Analyst*

I just wanted to verify some numbers on sort of the run rate and given the improvement and reasonably fast improvement as well with client retention. The revenue capture, when you said it was, I believe you said it was 10% for October, higher than three, so that would be 0.0044 or about there?

Steve Vigliotti - *Investment Technology Group Inc. - CFO*

Yeah, not to get cute but we guided it was more than 10% above the 40 mils in Q3.

Richard Repetto - *Sandler O'Neill & Partners - Analyst*

Could you give any more color on, you said the run rate exiting was higher, any more color on just business trends, client retention I guess in November?

Steve Vigliotti - *Investment Technology Group Inc. - CFO*

Just a couple days in November, Rich. But the last week of October volumes are roughly 10% higher than what we posted for the full month.

Richard Repetto - *Sandler O'Neill & Partners - Analyst*

Okay. And then on the Ross Smith sale, congratulations. Did that include, was there any additional research assets bundled in, you've taken a significant gain, is that the same Ross Smith that was acquired? Any additional ITG assets that went with it in the sale?

Steve Vigliotti - *Investment Technology Group Inc. - CFO*

Those were the energy assets, Rich, acquired in 2011.

Richard Repetto - *Sandler O'Neill & Partners - Analyst*

Okay. And I guess my last question is the strategic review that you committed to it sounds like it was done. And I guess you're probably not going to dictate or announce what other moves. But I guess, is there anything that differentiates say Majestic from the way you view it strategically from a Ross Smith? Or could you give us more color on how you view research, I guess, Jarrett?

Jarrett Lilien - *Investment Technology Group Inc. - Interim CEO*

Research has turned out to be actually a great asset and it's performed well at ITG. But I think really the theme here that you've seen the beginning of and I think will continue, as I said in the prepared remarks, it's about sharpening our business focus and it's about optimizing capital management. So, I think you'll continue to see us do that.

Richard Repetto - *Sandler O'Neill & Partners - Analyst*

That's all I had and congrats on making these steps forward.

Operator

Ken Worthington, JPMorgan.

Ken Worthington - *JPMorgan - Analyst*

Congratulations on the sale as well. Maybe just digging into the expenses. You gave some, I guess, some kind of loose guidance on the compensation. Maybe just sort of discuss or if you could quantify some of the one-time items. So, for example, compensation accruals or bonus accruals will be down. Some of those will be permanently gone and some of those will come back. What portion of the 3Q comp is permanently away versus what can come back?

Steve Vigliotti - *Investment Technology Group Inc. - CFO*

Ken, based on the number of adjustments I mentioned, the reversal of management comp, the market-to-market adjustment on liability awards and other executive departures, at a minimum on similar revenue levels in Q4, we would expect to see an increase in compensation of at least $4 million.

Ken Worthington - *JPMorgan - Analyst*

Okay. Thank you there. You mentioned the foregone revenue in the Canadian business. One of the pitches that was made is that research adds to kind of the fee rate that ITG was able to charge. I see that you are going to be able to continue distributing the research.

Did anything else change with the sale of that business besides, I think, it's the $30 million of revenue that you mentioned disappears in the associated costs?

Steve Vigliotti - *Investment Technology Group Inc. - CFO*

Yes, those are sort of the run rate numbers for the business on a standalone basis, Ken. Not to get too into the weeds, but because of the way we'll net certain pieces of the distribution fee, the ups and downs of expenses may not move exactly, but the net effect will be what, as I disclosed, the roughly 40% plus of that revenue item.

But as you mentioned, we continue to be the exclusive distributor of the product. We're really excited about that. It allows, I think, the team and Warburg to continue to invest in the product and us to continue to make this available to our clients, many of whom like to pay for that with trading at a higher rate. So, we think it's a win for all sides.

Ken Worthington - *JPMorgan - Analyst*

And then lastly, platform, TCA, Macgregor, the recurring businesses, ITG has been engrained with its clients. If one were to cancel those, it would take some time. Any thought that some of those installs, that business could still go away? Or based on everything you hear, those products are here to stay? Is there risk that even though revenue has stuck around thus far, there's a risk out a quarter or two that clients seek alternatives and we could actually see a dip again out a couple quarters?

Jarrett Lilien - *Investment Technology Group Inc. - Interim CEO*

My view is that there's always that kind of everyday business risk in a competitive marketplace which we are in. But I don't think we have any more than that risk to the business. We've got some of the top products in those areas. We compete well. So, I expect that we will continue on in competing well.

So, direct to your question, do we think there'll be any fallout from the SEC that you might see there? We think we're on our way home on that. And as I said, again in the prepared remarks, we're sort of halfway back and we're continuing in that direction. So, that's our focus and that's where we think we end up is getting back to where we were before August.

Operator

Ashley Serrao, Credit Suisse.

Ashley Serrao - *Credit Suisse - Analyst*

Jarrett, I heard your commentary on more clients returning to ITG so far in 4Q and you can see it in the rate capture as well. But I was just hoping you could share some more color on what the remaining hurdles are for those clients who haven't come back in full swing yet.

Jarrett Lilien - *Investment Technology Group Inc. - Interim CEO*

I think for us we just need to keep doing what we're doing which is to be in front of our customers and addressing what their business needs are.

I think for some of the remaining ones that are left, it's been a matter of, for some it's just completing their process and some firms have a longer process than others. With some other clients, it was seeing us do a couple things such as naming our permanent CEO.

So, my expectation is that it's just continuing to do what we're doing and it's really time based at this point as our clients finish their review process and get us turned back on.

Ashley Serrao - *Credit Suisse - Analyst*

Okay. And then just on capital management, I was hoping you could provide us an update on the progress made by the capital committee. Are they still evaluating any specific capital optimization actions? I was more specifically interested in the trade off and the cost benefit analysis around self-clearing.

Steve Vigliotti - *Investment Technology Group Inc. - CFO*

Ashley, we've been meeting regularly with the capital committee. We're going to meet with them in another week or so. Whenever we meet, those are the types of things we talk about whether our current structure, the way we're set up, is the most efficient use of our capital. Nothing specific to report on that now other than to tell you we are on it and we continue to review it.

Jarrett Lilien - *Investment Technology Group Inc. - Interim CEO*

And just to add, capital optimization is one of our top priorities and top focuses.

Ashley Serrao - *Credit Suisse - Analyst*

Congratulations taking the next steps here.

Operator

Chris Allen, Evercore.

Chris Allen - *Evercore ISI - Analyst*

Just following up on Ashley's first question about clients coming back onboard. The remaining clients that you're still working to come back onboard, are they skewed more towards sell-side clients or buy-side clients?

Steve Vigliotti - *Investment Technology Group Inc. - CFO*

More of buy-side, Chris.

Chris Allen - *Evercore ISI - Analyst*

Okay. And then, just on research, just looking at the profitability in that segment, and once you back out the Ross Smith segment, I'm coming up with about $5 million loss from a pre-tax basis on an annualized basis. Do those numbers sound right for what's left in research and how you think about kind of potentially unprofitable businesses moving forward?

Steve Vigliotti - *Investment Technology Group Inc. - CFO*

Chris, no question energy research was the biggest contributor to that product's group's profitability. And once we closed the deal and move that out, we may see some movement and some share costs that get put there. So, it may not be dollar for dollar as you're lining it up today.

I'll just note, as Jarrett mentioned, even after the sale of energy research and the continuation of our ongoing relationship with the new company through the distribution arrangement we have, that product group continues to have some pretty valuable assets, including the consumer tech, TMT and macro research coverage as well as the portfolio trading teams we have globally.

So, it's still an important unit for us. We're going to obviously continue to work on that business model and optimize it as best we can.

Operator

This concludes our question and answer session. I would now like to turn the conference back over to Jarrett Lilien for any closing remarks. Please go ahead.

Jarrett Lilien - *Investment Technology Group Inc. - Interim CEO*

Thank you everyone for joining today and a special thanks to everyone on the ITG team. As I said earlier, really tough backdrop. Everybody's done a tremendous job in the past quarter, so thank you and we'll look forward to keeping it up in quarters to come.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.
