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Investment Technology Group, Inc. (ITG)

Q4 2013 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you for joining us to discuss ITG's Fourth Quarter 2013 Results. My name is Chad and I will help 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. All parties will be in a listen-only mode. [Operator Instructions] As a reminder, this session is being recorded.

I would now like to turn the call over to J.T. Farley of ITG. Please go ahead, sir.

James T. Farley
Head-Investor & Media Relations, Investment Technology Group, Inc.

Thank you, Chad, 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.

I would also like to 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 in the Investor Relations section of itg.com. Speaking this morning are ITG's CEO, Bob Gasser; and CFO, Steve Vigliotti.

To start, I would like to turn it over to Bob.

Bob C. Gasser

President, Chief Executive Officer & Director, Investment Technology Group, Inc.

Thanks, J. T. Thank you all for joining us to discuss ITG's fourth quarter 2013 results. We believe this quarter's financial performance continue to reflect our strategy of establishing a truly global set of product capabilities while still managing costs.

Revenue grew 9% over last year, driven by higher results in our international segment, including a record quarter for Europe. European revenue grew almost 57%, while the profit contribution from the region more than tripled. This provided an important offset to the tough U.S. environment. The average daily volume of combined New York Stock Exchange and NASDAQ listed volumes declined 1% compared to the already low levels in the fourth quarter of 2012.

Domestic equity mutual funds posted approximately $11 billion in inflows during the quarter, reflecting, in part, a rotation from bond funds, which saw outflows of $58 billion. While the inflows are a good sign, we haven't seen that translate into trading volumes.

Competitively, we believe the strong IPO calendar may have negatively impacted us during the quarter, as some trading volume may have shifted to investment banking firms, which were book runners on these offerings. International equity funds continue to benefit from the rotation out of bonds, posting inflows of approximately $42 billion during the quarter.

Taking a closer look at our U.S. results, our average U.S. revenue per share rose year-over-year from $0.0043 to $0.0047, but it was down sequentially due to a higher mix of sell-side volume, as well as a slight decrease in average buy-side revenue per share. As a reminder, our average rate card is heavily dependent on our product mix and will fluctuate from quarter-to-quarter based on this mix.

Despite the lower overall volumes, we continue to gain traction with our POSIT Alert buy-side block crossing network, with the U.S. volumes up 3% over the fourth quarter of 2012 and average trade size of more than 31,000 shares.

Overall, it's a tough quarter in the U.S., but we are able to maintain profitability due in part to our product and focus, which led to dramatic improvements in our operating efficiency. As I mentioned, our international results improved significantly during the fourth quarter, led by Europe. While market conditions were more favorable to our business than a year ago, due mainly to institutional inflows into European equities and a growing demand for dark liquidity, our outperformance reflected the impact of the targeted investments we have made in our infrastructure and products to expand our client base and grow POSIT's liquidity.

Average daily value trading in POSIT doubled in Europe, while POSIT Alert volume more than tripled during the fourth quarter as compared to the fourth quarter of 2012. ITG now represents more than 12% of total European dark trading, up from less than 5% in the first quarter of 2011.

You may have seen European legislators recently agreed to the MiFID II directives. Among them, caps on dark pool trading and increased regulatory oversight of algorithms. Our predominant use of midpoint pricing will lessen the impact on POSIT. However, further clarity is needed on how the dark pool caps will be imposed given the lack of consolidated take.

Based on our preliminary review, POSIT's market share in any single name in the current FTSE 100 stock universe is under 2%, below the planned 4% cap. We understand the MiFID II caps on dark trading will exclude block trades executed under the large in-scale waiver, and if so, this mechanism offers POSIT Alert trade the potential to avoid the caps. Additionally, POSIT's structure is a multi-lateral trading facility or MTF as opposed to a broker internalization pool, which gives us an advantage over many other European dark pools under the new regulations.

It's too early to try to quantify any impact from these regulations. But overall, we are cautiously optimistic that they will not pose serious difficulties for the trajectory of our European business. We believe the breadth of our dark liquidity capabilities developed over 27 years gives us maximum flexibility relative to our competitors.

With these regulatory changes, barriers to entry in the European equity space will likely be raised to new heights. While we are watching all these developments closely, we do not expect implementation of MiFID II before 2017.

Turning to our Asia Pacific operations, we posted revenues of $11.4 million, an increase of 19%, while our quarterly loss fell by more than 80% over the prior year period. Our average value trade in the region rose 28% versus the fourth quarter of 2012, outpacing the 20% increase in Pan-Asian market volumes over the same period.

We see a big opportunity for POSIT Alert in 2014. It is now live in 30 countries globally, and we expect to add at least two more this year. We're just scratching the surface of the Asia Pacific dark block opportunity, but anticipate this will be a driver of growth for ITG's AP business in 2014.

In Canada, market volumes were flat, capping a challenging year, which saw some broker dealers exiting the market altogether. Despite this, our revenues grew 4% compared to the fourth quarter of 2012. Even with this outperformance, our profitability dipped due to an accounting charge for employee stock award valuations.

Turning to ITG Investment Research, we recently launched coverage of ADT, Harley Davidson, and Aereo, made alpha-generating research calls on names such as Starbucks, T-Mobile, Groupon, and PetSmart, and launched pre-IPO reports on Rice Energy, RSP and EP Energy. We also hosted two energy conferences in November, which featured only presentations from ITGIR analysts with no corporate access. These events drew more than 250 clients from institutional investors and private equity firms.

Looking at our overall cost structure, we will continue to focus on product profitability to improve performance, particularly in the U.S. We expect this focus to yield some incremental cost savings both in 2014 and over the longer term.

I would like to point out that while we expect our core cost base to decrease with these efforts, we are also evaluating some investments for growth in new business areas, which could offset these savings in 2014.

Wrapping up, I believe our results this quarter and for the full year 2013 demonstrate our ability to improve our performance even when business conditions are less than optimal, but we're not standing still. We're working to develop innovative new offerings for our clients to solidify our leadership position in electronic execution and research.

2013 clearly raised the bar for ITG. But I remain confident in our team's ability to raise it once again in 2014. We will continue to be relentless in our pursuit of operating improvement and business opportunities that fit well with our powerful global capabilities.

With that, I'd like to turn it over to our Chief Financial Officer, Steve Vigliotti, to review the fourth quarter and full year financial results.

Steven R. Vigliotti

Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

Thanks, Bob, and good morning, everyone. A record quarter for our European operations drove a sharp jump in net income during the fourth quarter, capping a full year in which we saw a strong rebound in profitability.

As noted on slide eight, we generated consolidated revenues of $131.9 million during the fourth quarter, 3% higher than the third quarter of 2013, and 9% higher than the fourth quarter of 2012. We posted GAAP net income of $0.26 per share in the fourth quarter of 2013, compared to GAAP net income of $0.20 per share in the third quarter of 2013, and a GAAP net loss of $0.17 per share in the fourth quarter of 2012.

On slide nine, we have detailed the non-operating items included in our GAAP results for the fourth quarter of 2012. There were no non-operating items in either the fourth quarter or the third quarter of 2013. In the fourth quarter of 2012, we incurred a restructuring charge related to a cost reduction plan, and we incurred duplicate rent charges, while we built out our new headquarters in Lower Manhattan. For the rest of this discussion, all references to results and costs for the fourth quarter of 2012 will be on an adjusted basis, excluding these items.

Slide 10 presents our consolidated results along with separate breakdowns of the results from our U.S. and international operations. On a year-over-year comparative basis, consolidated expenses were up $2.1 million, including the variable costs associated with a $10.4 million increase in revenues.

Our consolidated pre-tax margin was 8.1%, down slightly from 8.4% in the third quarter of 2013, but up sharply from 1.9% in the fourth quarter of 2012. Our consolidated effective tax rate was 9.2% for the quarter, reflecting the high mix of earnings from our international operations and a $900,000 benefit from resolving a tax contingency in the UK.

During the fourth quarter of 2013, we posted net income of $0.01 per share in the U.S. on revenues of $75.3 million, down from $0.07 per share in the third quarter of 2013, due to lower volume levels and a dip in our average rate per share, but up from a loss of $0.03 per share in the fourth quarter of 2012.

Our fourth quarter 2013 U.S. results included a gain in our stock loan business that added $2.5 million to other revenue and approximately $1.1 million in after-tax earnings after related cost and taxes. Our fourth quarter pre-tax margin in the U.S. was 1.2%, down from the third quarter of 2013 and up from the fourth quarter of 2012.

As a reminder, the U.S. segment bears nearly all of the firm's corporate costs, which negatively impacts pre-tax margins reported for that segment. These costs, which totaled approximately $5 million per quarter, include among others the cost of being a public company, intangible amortization, interest expense, and a cost of maintaining our global transfer pricing structure.

Excluding these costs, our U.S. pre-tax margin in the fourth quarter would've been 8%. Our combined international businesses posted net income in the fourth quarter of $0.25 per share and revenues of $56.6 million. Our international pre-tax margin rate was 17.2%.

On slide 11, you can see that our U.S. expenses declined $2.9 million from $77.3 million in the fourth quarter of 2012, due chiefly to lower transaction processing costs associated with reduced trading activity and our efforts to reduce market data and connectivity costs, offset though by higher compensation costs as our compensation ratio increased to 42% due in part to improved global profitability. Transaction processing costs, as a percentage of revenue, were down to 12% versus 13.2% in the third quarter of 2013 and 15.5% in the third quarter of 2012.

On slide 12, we provide a summary of our international results. Revenues were up $5.9 million from the third quarter of 2013 and $12.2 million over the fourth quarter of 2012. Our record European revenues continue to outpace the change in value traded market-wide, reflecting our market share gains, while our Canada and Asia Pacific operations both posted solid revenue growth compared to the third quarter of 2013 and the fourth quarter of 2012.

International expenses were higher than the third quarter of 2013 and the fourth quarter of 2012 due largely to the impact of transaction processing and variable compensation cost on higher revenue levels. The compensation ratio for our combined international operations was 33.9%. This ratio was lower than both the third quarter of 2013 and the fourth quarter of 2012 and reflects in part a year-end adjustment for an increase in the use of deferred compensation in our European business.

Combined international transaction processing costs, during the quarter, as a percentage of revenue were 19.3%, slightly higher than both the third quarter of 2013 and the fourth quarter of 2012.

On the next slide, we tracked the performance of our foreign segments over the past five quarters. As compared to both the third quarter of 2013 and the fourth quarter of 2012, revenues were up in Canada and Asia-Pacific, while Europe hosted record revenues and record pre-tax profitability.

Canada's results were negatively impacted by an incremental accounting charge incurred for cash sales stock awards of $1.5 million, due to the sharp increase in ITG's stock price during the quarter. Starting in the first quarter of 2014, we plan to grant awards for our Canadian employees that we'll settle in stock instead of cash, which will reduce the impact of these variable charges over time.

On slide 14, we offer supplementary information on revenues broken out by our four product groups for the last five quarters. The table also includes our corporate group, which primarily reflects investment income that is not directly attributable to any of the product groups.

As you can see from this table, Electronic Brokerage revenues were up both year-over-year and sequentially, driven in part by increased activity in Europe. Revenues from Research, Sales and Trading were fairly stable compared to both the third quarter of 2013 and the fourth quarter of 2012.

We saw modest sequential increases in both our Analytics and Platforms groups during the fourth quarter of 2013. As a reminder, roughly half the revenues for these product groups is recurring. The other half is commissions. The Platforms group shares in Electronic Brokerage revenues transacted off the ITG front ends whether executed with third-party brokers or with ITG.

The slight decline in Platforms revenue from the fourth quarter of 2012 reflects a decline in revenue derived from our OMS platform, mostly offset by growth in revenue derived from our Triton EMS. The Analytics group recognizes commissions for bundled products ratably based on a fixed subscription amount from cash-paying clients.

Our focus on product group profitability during 2013 led to improved operating efficiency and we'll continue to be part of our management process going forward.

On slide 15, we are presenting for the first time supplementary pre-tax income information for our four product groups and for our corporate function for the full year 2013. While we are only providing this information on a full year basis, we will provide on a quarter-by-quarter basis going forward. Please note that we are still primarily organized by geographic regions for the purpose of allocating resources and measuring performance and thus, expect to continue to use geographic regions as our reportable segments.

This supplementary product group financial information is intended to provide more transparency into the drivers of our business.

You'll notice that pre-tax margin for our Electronic Brokerage group is the highest of the four, perhaps not surprising given the scale of that group. Electronic Brokerage, Platforms, and Analytics, all saw a margin improvement in 2013, due in part to the increased focus on product group results.

The margins are lowest in the Research, Sales and Trading unit, but please note that this group comprises not only ITG Investment Research, but also our high-touch portfolio trading and sales trading efforts on a global basis.

On slide 16, we have presented our U.S. volume and rate capture statistics. Average daily executed volume was down 4% versus the third quarter of 2013 and down 18% versus the fourth quarter of 2012. Our average overall revenue capture rate per share dipped from $0.0049 in the third of 2013 to $0.0047 due to an increase in the sell-side mix, as well as a slight dip in average buy-side trading commissions.

The percentage of sell-side volume rose to 53% from 51% in the third quarter of 2013. We ended the quarter with $261.9 million of cash and cash equivalents on our balance sheet, almost unchanged from $261.6 million at the end of the third quarter of 2013. Our excess cash on hand, over and above what we need for regulatory capital, debt payments, and compensation liabilities was consistent with the third quarter at approximately $60 million.

During the fourth quarter, we repurchased 212,000 shares for $4.2 million or $19.65 per share. This amounted to 43% of our earnings during the quarter. As a reminder, our buyback program has reduced shares outstanding, net of issuances by more than 17% over the past four years.

Looking forward, I would like to offer the following observations. As previously guided, our stock repurchases will be made more on an opportunistic basis going forward and will depend in part on market conditions. While repurchase levels may not be directly tied to our level of earnings each quarter, we do expect to maintain at a minimum the level we repurchased this past quarter to offset dilution from issuances under our stock-based compensation programs.

As of December 31, we have 3.4 million shares available for repurchase under our current buyback authorization.

Regarding current business conditions, our average U.S. daily volume for January was approximately 160 million shares at an average rate generally in line with the fourth quarter 2013 average. In our combined international business, our average daily commissions in January were approximately 10% better than our fourth quarter average, driven primarily by continued growth in Europe.

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

QUESTION AND ANSWER SECTION

Operator: Sure. We will now begin the question-and-answer session. [Operator Instructions] At this time, we will pause momentarily to assemble our roster. Our first question comes today from Rich Repetto with Sandler O'Neill. Please go ahead.

Richard H. Repetto
Analyst, Sandler O'Neill & Partners LP

Q

Yeah. Good morning, Bob. Good morning, Steve.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Hi, Rich.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

Hi, Rich.

Richard H. Repetto
Analyst, Sandler O'Neill & Partners LP

Q

My question – thank you, as you promised the segment margins. And I know you did mention, Steve, in the prepared remarks that there was more cost efficiencies, but we were also – thought with the full margin sort of analysis by segment that there might be additional cost saves. Is there a potential for more cost saves with the full disclosure of the segments now? And also, is there a potential, Bob, I guess, given the outlook in the U.S. or the performance of the U.S.?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Yeah. I mean, as I said in my prepared remarks, Rich, we're going to be relentless in terms of focusing on operating performance. We certainly believe that in the coming year, we have some opportunities to continue to reduce costs and improve the operating performance of those units. And now, you'll obviously get more granularity in terms of exactly where that's coming from.

But clearly, we continue to look at market data; we continue to look at our infrastructure; we continue to look at connectivity. Regionally, within Asia-Pac, we think there're some very, very good opportunities to share some best practices cross-border. So I think there's – we feel very confident and very optimistic that we'll continue to extract marginal improvement.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

Yeah, Richard, as I mentioned, the results that we provided by product group here are the full year results. And for Electronic Brokerage, Platforms and Analytics, there were meaningful cost savings and margin improvement in all three of those due to the focus we had on improving product group profitability this year. You'll be able to see now going forward, when we present this information quarterly, you'll be able to check our progress in each of these groups on a go forward basis.

Richard H. Repetto
Analyst, Sandler O'Neill & Partners LP

Q

Right. But there's no set target for 2014 by product group profitability, or is there?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

None that we're going to provide today.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Yeah.

Richard H. Repetto
Analyst, Sandler O'Neill & Partners LP

Q

Okay. And then, Bob, the European profitability is just notable, outstanding. And I guess going forward, given the contribution from Europe, is there potential for, say, volume metrics, revenue capturing stuff from Europe as well given that it was $0.25 of the $0.26 in the quarter?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

I think we've probably gone about as far as we're going to go for the time being in terms of, for instance, the disclosure of POSIT growth, et cetera. POSIT Alert within that is obviously becoming more important given the MiFID II regulations and the block exemption that we believe will exist.

So I think we'll continue to give out that information. And most importantly, one thing to remember about the U.S. is the U.S. is a pretty heavy contributor of volume to Europe and has kept pace in terms of Europe's growth and the contribution that comes out of the U.S. And it's also a very important contributor to the AP region.

So I think the U.S. remains a strong area of focus, but it also has been a significant contributor to the global results. And clearly, we do look at this now as a global enterprise.

Richard H. Repetto
Analyst, Sandler O'Neill & Partners LP

Q

Got it. Got it. Excuse me, I got the cough too. Very last quick one, Steve, the one-timers in the quarter, I think you said Canada, the cash stock award or something like that, and then you also said I thought U.S. would have had 8% margins, if not for – and I missed that point. Are those one-timers as well?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

No, those are not one-timers. So the 8% adjusted margin, if you will, for the U.S. reflected a carve-out of the corporate costs, because all of those are borne by the U.S. segment. So when you compare region by region, we just want you to keep in mind that pretty much all those corporate costs are sitting in the U.S.

Richard H. Repetto
Analyst, Sandler O'Neill & Partners LP

Q

And Canada, would that be viewed as a one-time cost or?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

So in Canada, yeah, let me give you a little color on that. So in Canada, the awards we've issued as part of our compensation program to Canadian employees because of various tax reasons in the past are to be cash settled, not settled with the issuance of stock. As a result, we have from time to time variable charges on those awards depending on the movement of our stock price, because we have to make a cash payment equal to the value of that stock. And as you know, we had a large increase in the stock valuation during the fourth quarter and as a result, that variable charge over and above would have been, had it been just pure fixed rate accounting like we have in all the other regions, added about $1.5 million to costs in Canada.

Richard H. Repetto
Analyst, Sandler O'Neill & Partners LP

Q

Got it. Okay, congrats on the strong quarter, guys.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Thanks, Rich.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

Thanks, Rich.

Operator: Our next question comes from Ken Worthington with JPMorgan.

Kenneth B. Worthington
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

Good morning, Ken.

Kenneth B. Worthington
Analyst, JPMorgan Securities LLC

Q

First, on POSIT, and really POSIT in Europe. So more than any other business, it seems like in POSIT liquidity begets liquidity, you've got 12% – I think you said 12% dark share in Europe. But it would seem as market share goes higher, the value proposition strengthens. So in terms of customer penetration, like it would seem you're in a sweet spot, do you see things accelerating here, because, as POSIT gets bigger and there's more liquidity in the pool, it becomes more valuable. And you see that kind of pile-on effect. And I guess where are we in that kind of customer pile-on effect, like it would appear to be growing nicely. Is it fifth inning, seventh inning? And at what point do you start to push up against some sort of constraints on that? I think I've got like 10 questions in there.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Yeah, exactly. And a statement, maybe. So I think that just looking at POSIT Alert, and particularly in Europe, but we do look at it as a global business, as we indicated, and we do think that there is significant opportunity to do much of the same in AP, maybe on a smaller scale, but we really are very excited by the Asia-Pac potential there.

But on the European POSIT Alert side, I think that we continue to see great momentum, as Steve alluded in January, as these guys have started right where they left off and more. So we're feeling very good about that. We do think that the flexibility to model, particularly block liquidity and the block exemption, is really, really important now, and have scarcity value regarding the potential changes with MiFID II.

And it's just – I mean dating back to probably the May and August, November calls last year, we talked about the notion of deploying this new global ticket in front-end and one point of access to the globe through that and we believe that we have caught up and potentially surpassed our main competitor there in terms of functionality, capability, ease-of-use, overall client experience.

So I think we're in the fifth or sixth inning of the POSIT Alert of revolution there in Europe and the team – I got to give the team, I just have to commend them they've done an exceptional job of laying the groundwork over the past several years and now harvesting on the investment. And so, I do believe we've got more runway.

Kenneth B. Worthington
Analyst, JPMorgan Securities LLC

Q

In terms of kind of customer penetration, like, if you look at, I don't know, the McLaughlin big commission payers, are you there? Are you still kind of building out? Are you hitting half, are you hitting 90%?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Just I mean – no, I think there're still some gaps. There're still some places where I think we can close the market share. We can gain some market share and then there's late adopters. And certainly, amongst the Continental European big institutions, there are some big names there in the McLaughlin lists that are now, just now, starting to really embrace the concept.

Kenneth B. Worthington
Analyst, JPMorgan Securities LLC

Q

Okay. Great. One other, in terms of the buy-side sell-side mix, as you look at kind of 4Q, what were the key drivers? I assume it was kind of a surge in sell – I'm sorry, a decline in buy-side rather than a surge in sell-side volume, but I could be wrong. And then, with volumes, at least for the industry, kind of rebounding in 1Q, does that bode maybe well or poorly for the mixes when we think about the current period?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Let me – I'll let Steve answer the first question. I'll answer the second question. I think we're off to a very solid start in the U.S. As I said, in Europe, we're off to a fantastic start. AP and Canada are about where we left off. So I think we're in a good shape. And to the mix issue, I'll let Steve talk about sell-side -

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

Yeah, I mean Ken, both buy-side and sell-side volumes were off sequentially from Q3, although as the math would indicate the buy-side was off more, sequentially, than the sell-side was.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Yeah. And just to remind everybody, I am absolutely still focused on the rate card, right? So there's a notion that within our full service product capability with institutions now, this is a great time of the year. The turning point we review in 2013, our results and our relationships and partnerships. And thinking about 2014, are there places where we can continue to improve on that with existing clients? And that's something that I've been spending a lot of time and energy personally on – and I believe that we still have opportunities to improve on that.

Kenneth B. Worthington
Analyst, JPMorgan Securities LLC

Q

Okay, great. Thank you very much.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Thanks, Ken.

Operator: Our next question comes from Patrick O'Shaughnessy with Raymond James.

Patrick J. O'Shaughnessy
Analyst, Raymond James & Associates, Inc.

Q

Hey. Good morning, guys.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Good morning, Patrick.

Patrick J. O'Shaughnessy
Analyst, Raymond James & Associates, Inc.

Q

And so, following up on that last question, the modest rate card compression that we saw in the U.S. in the fourth quarter, how much of that was just a function of the mix shift towards a little bit more sell-side and how much was just seeing some more competitive pressure out there?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

It's about half and half. About half of the $0.002 drop related to the increase in mix from the sell-side and the balance, again, related to just a slight – as we said, a slight decline in the average buy-side rate.

Patrick J. O'Shaughnessy
Analyst, Raymond James & Associates, Inc.

Q

Okay. Appreciate that. And then a little bit of housekeeping. Steve, I think you mentioned that the quarter-over-quarter increase in other revenue was attributable to securities lending. Did I hear that right?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc. **A**

You did, yeah. We had a gain in our securities lending business, which pushed it up about $2.5 million higher than the usual run rate there.

Patrick J. O'Shaughnessy
Analyst, Raymond James & Associates, Inc. **Q**

Okay. And should we expect that's kind of more a one-time gain in nature?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc. **A**

Yeah. Yeah. I wouldn't expect that going forward. After related costs and taxes, that added about $1.1 million to earnings.

Patrick J. O'Shaughnessy
Analyst, Raymond James & Associates, Inc. **Q**

Okay. Got you. Appreciate that color. And then I guess just getting back to POSIT, and POSIT in Europe and POSIT in Asia, could you just talk about what the competitive landscape over there looks like for the product, because obviously here in the U.S., I think that we all know there's a ton dark pools and a ton of competition in that space, can you talk about what you're seeing over in Europe and over in Asia that gets you optimistic about what your opportunity over there is?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc. **A**

Yeah, I mean I think in Europe, it really is ourselves and Liquidnet head-to-head. We're the only block sweeping, block matching alternatives there. As I said, I do believe that MiFID II is basically shaking and stirred the market quite a bit. It's not going to be implemented for three years. That's our estimate in terms of the timeline. But in the interim, I think that those assets become very valuable.

And I think most importantly, the flexibility of our model, in terms of the improved price, we have block liquidity that's unique to us. In the U.S., you guys know that we have an alternate capability that has the ability to trade for spread. There's all kinds of things and we can pull out of our tool bag to address the regulatory environment there.

In Asia, I think it's very early innings for us. Liquidnet has a significant lead in the business, but has not had much competition. But now, obviously, we aim to change that. And I think it is green shoots in Asia-Pac and I think that the notion of managing liquidity in POSIT and all the things that we do in Europe very effectively, we're looking for more and more opportunities to do them in Asia, because I think everyone can take away one thing from this conversation is that managing liquidity, managing transaction processing costs, managing clearing costs, and in the case of Asia, managing your capital are all very, very important to the bottom line impact.

Patrick J. O'Shaughnessy
Analyst, Raymond James & Associates, Inc. **Q**

Okay. I appreciate that discussion. Last one from me, Steve, so if I take kind of the one-time tax benefit that you talked about and I add that back to your tax rate, I think you guys came to about an 18% normalized tax rate for the quarter, and obviously, that's going to be dependent upon the mix of where your revenues come up. But as we think about modeling out 2014, what sort of tax rates are you comfortable with us using?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

Okay. Fair question. I think it's probably best to answer that by breaking it down between the U.S. and international operations. The U.S. tax rate is typically in the low to mid-40% range. It was a little higher this quarter due to the impact of some book tax adjustments on lower levels of pre-tax income.

As we mentioned in the release and in our prepared remarks, the international taxes will reduce by $900,000 this quarter, related to the resolution of the contingency. Excluding that benefit, our international tax rate, this quarter was around 15%. This rate is a little lower than Q3's rate, which – international rate which is around 20%. And that's going to fluctuate perhaps based on the mix. Within the international business in this quarter more of it came from Europe, where we have a lower effective tax rate, let's say, than in comparison to Canada. So probably depending on the mix of the international business, it could be anywhere from 15% to 20% at current business levels.

Patrick J. O'Shaughnessy
Analyst, Raymond James & Associates, Inc.

Q

All right. Makes sense to me. Thank you very much, guys.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.

A

Okay.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Thank you.

Operator: Our next question comes from Niamh Alexander of KBW.

Niamh Alexander
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi. Thanks for taking my questions.

A

Hi, Niamh.

Niamh Alexander
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Bob, you mentioned – sorry, Steve, you've mentioned earlier on that you did see a little bit more on the saving side, but you were evaluating investments, so we should kind of expect those savings to be put towards investments. Can you expand a little bit on what – is it kind of new products or improving on existing products or what exactly you're thinking about there?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.
A

Yeah, I think we – over the course of this year, I think you'll get more and more insight into the answers to those questions, which are – I think we're very reticent to talk about things that are not in production or ready to – for clients to transact. But rest assured that we do believe that taking a portion of the incremental value this year that we can take from the operating – from the expense base and reinvesting that in what we think will be growth drivers for, not the next year, but the next five years, is absolutely the right thing to do, diversify our revenue stream, diversify the client base, diversify the geographies. All those things are very, very important. I mean just look at the geographies and how important that's become to the firm.

But the discipline, the same operating principles apply. There's no initiative within this firm that does not have an income statement and resources that have been identified and that are being measured, performance is being measured, and there's no – there certainly is no unlimited ability to spend on those things. So we're going to stay very tightly focused.

Niamh Alexander
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Okay. And Bob, you're talking about diversification there. I mean, is inorganic on the table as well?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.
A

I wouldn't comment on strategic potential there in terms of other assets. But we don't see anything on the horizon that would be hugely strategic, but I don't want to comment on other assets in the marketplace.

Niamh Alexander
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Okay. Fair enough. Thanks. And then, if I just could push back on the taxing, Steve, Asia is getting really, really close to getting into the black there and you have a bunch of tax losses that you could, maybe, start using this year. What kind – you've given us the guidance of like 15% to 20%, but if you [ph] can't (36:59) start using those losses, maybe give us a sense of in terms of even the number or the millions of dollars that we could start to apply towards that tax rate otherwise, or is 15% to 20% including, maybe, turning to the black in Asia as well?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.
A

Well, the 15% to 20% I gave was basically the range between Q3 and Q4, and how the mix of the international profitability shifted more to Europe in Q4 versus Q3. Obviously, we're not giving guidance specifically on Asia's profitability over the next 12 months. But what I will tell you that to the extent we do generate profits, that we have more than $30 million of gross loss carry-forwards in both Hong Kong and Australia. So on a tax effected basis, those losses could shield about $16 million of taxes combined.

Niamh Alexander
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Okay. That's really helpful. Thanks, Steve. I appreciate it.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.
A

Okay.

Niamh Alexander
Analyst, Keefe, Bruyette & Woods, Inc.

Q

And then just lastly, going back to the U.S., because I mean the international was phenomenal this quarter and it seems like you're off to double-digit growth again into the first quarter. But in the U.S., it just seems like you've been losing a bit of market share and now you've had a bit of rate card deterioration and you kind of explained some of it. But is there something else here? Is there a change in client behavior? Is it because the deal environment is so strong? Because if that persists, then we shouldn't expect kind of more market share gains for a while yet, is that fair?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Yeah. I think the deal environment is obviously very strong, or it has been strong. We'll see if that persists. McLaughlin, I think, estimates that selling concessions were up 56% year-over-year. That's obviously, been a big driver particularly for the bulge bracket. And certainly, we know how there is a significant correlation between the quality and the performance of the calendar with secondary commissions for some of those folks, which is I think well-known to everyone.

But I don't know that there's been a significant change outside of that in terms of client behavior or mix within the firm. I'm not talking about the buy-side sell-side mix. I'm talking about the mix of products and services they use here. I do think that the research offering gives us the ability, as I said earlier, to have these conversations about rate card and to revisit them, particularly as we look back on 2013 and some of our bigger client partnerships.

So I'm sanguine about the U.S. I do think Q4 is – there's no denying it was a weak quarter relative to the first three. But I would take that – going back to the calendar, I think it's a good thing overall for the market, a good thing for more float, some volatile [ph] growth names (39:34), some excitement around equities in general, but – and that's for the long-term.

For the shorter term, clearly, I think it could affect us negatively as it did in Q4. But January is an improvement over December, and we're going to work hard to continue to extract some market share gains and some more volume in the rest of the quarter.

Niamh Alexander
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Thanks. I'll get back in the line.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

A

Thanks, Niamh.

Operator: Our next question comes from Chris Allen with Evercore.

Chris J. Allen
Analyst, Evercore Partners (Securities)

Q

Good morning, guys.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.
A

Hey, Chris.

Chris J. Allen
Analyst, Evercore Partners (Securities)
Q

A couple of questions. One, just on the Research, Sales and Trading margins, no surprise they were the lowest out of your different business groups. But if I recall correctly, Ross Smith margins were north of 20% and I believe Majestic, the expectations were for margins in 10% to 15%. I'm just wondering how big of a drag if those numbers are roughly correct, you're actually seeing from the high-touch sales and sales trading businesses.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.
A

Well, a couple of things now, Chris. The product group disclosure is on a global basis, right? So in addition to including sales and trading and portfolio trading, it also includes the operations – those operations on a global basis and other than really North America, we don't have a research offering or much of research offering in Europe and AP at this point in time.

So it's really not – it's hard to compare those pre-acquisition margins or pre-acquisition expectations to this full product group disclosure here, which includes other operations and both from a non-research perspective as well as a global footprint as well.

Chris J. Allen
Analyst, Evercore Partners (Securities)
Q

Okay. And then I believe you've mentioned that you've made changes in European compensation with more deferrals. Can you give us any color on that?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.
A

Yeah, just obviously, we had a very successful year in Europe and the amount that we had been accruing throughout the course of the year, as we got the year-end for compensation, we elected to use more of that to compensate folks over the longer term with stock. And when you do that, you don't have a current period expense that ends up becoming an expense over future periods as those awards vest. So, as a result, we pull back a little bit of comp for the fourth quarter related to that.

Chris J. Allen
Analyst, Evercore Partners (Securities)
Q

Got it. That's it for me. Thanks, guys.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.
A

Okay.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.
A

Thanks.

Operator: Our next question is from Michael Wong with Morningstar.

Michael Wong
Analyst, Morningstar Research
Q

Good morning.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.
A

Good morning, Michael.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.
A

Good morning.

Michael Wong
Analyst, Morningstar Research
Q

You certainly experienced great growth in your European business, but I'm just wondering if any of the talks about market reforms in Europe like MiFID II or EMIR have affected your European product roll-out schedule or increased the reluctance of European training firms to adopt your products and prevented, maybe, even better results?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.
A

Yeah, I don't think it's changed our product development or our plans for continued roll-out at all. So as I said, I think that we feel very constructive about what we know at this stage of the game, which is looking at the races there as they currently exist and the potential, as I said earlier, which is really, really important to note, the block trade exemption. And so, remember that when we talk about POSIT volumes in Europe, the block volumes are a proportion of that, right? So we think there's a lot of flexibility that we have to respond to these changes.

Michael Wong
Analyst, Morningstar Research
Q

Okay. And just with the U.S. rate card, I'm just wondering if you're on boarding or have any active efforts where you seek to increase your sell-side volume even though I heard your rate card is still incremental revenue and presumably you have excess capacity?

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.
A

That's correct. I mean that was the strategy going into expanding to that client base, right. We had the capacity. We felt that we could generate incremental profitability. So that's our primary focus as it continued to generate incremental profitability.

Michael Wong
Analyst, Morningstar Research
Q

Okay.

Steven R. Vigliotti
Chief Financial Officer & Managing Director, Investment Technology Group, Inc.
A

But as Bob mentioned, when we look at our buy-side client base, we are very focused on improving the rate card there and looking at the full value of the services we offer and making sure that we're getting compensated appropriately for that.

Michael Wong
Analyst, Morningstar Research
Q

Okay. Thank you.

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.
A

Thank you.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to Bob Gasser for any closing remarks. Sir?

Bob C. Gasser
President, Chief Executive Officer & Director, Investment Technology Group, Inc.

We thank you very much for joining us this morning. We look forward to speaking with you, I believe, it's in the first week of May. Take care.

Operator: Thank you very much. The conference is now concluded. Thank you for attending. You may now disconnect.