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ITG - Q4 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 fourth-quarter 2015 results. My name is Austin and I will facilitate the call today.

(Operator Instructions)

As reminder, this session is being recorded. I would now like to turn the call over to JT Farley of ITG.

JT Farley - *Investment Technology Group Inc - Managing Director of IR and Corporate Communications*

Thank you, Austin, 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 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 in the investor relations section of ITG.com. Speaking this morning are ITG's CEO and President, Frank Troise; and CFO, Steve Vigliotti. To start, I would like to turn it over to Frank.

Frank Troise - *Investment Technology Group Inc - CEO & President*

Thank you, JT, and thank all of you for joining the call this morning. It is great to be back on the ITG team. I'm honored to have this opportunity to lead a firm with such a distinguished history of delivering innovative solutions and world-class client service.

I've been here just under three weeks and I've already had a chance to listen and learn from many of my partners. We have a strong foundation to build upon and are capable of being even stronger. I'm very excited about our prospects.

My objective is to work with our leadership and the Board to set a course for long-term growth. Today I'd like to introduce myself and speak briefly about my plans for the next few months. Before I do so, I'll turn the call over to Steve to review the fourth quarter. Steve, all yours.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Thank you, Frank, and good morning, everyone. Although adjusted fourth-quarter 2015 results were not positive, we did make steady progress on our recovery from the lows after the SEC settlement last summer. And we closed the sale of Energy Research, unlocking significant value for stockholders.

Daily trading commissions in the U.S. during the quarter were 12% better than the levels of August and September. Market share in Asia-Pacific improved and Europe posted strong results, thanks in part to new record market share in POSIT and overall.

Our total revenues declined slightly as compared with the third quarter of 2015 but that was largely due to the impact of the strong month of July on our third-quarter results. On a GAAP basis we generated revenues of $224.2 million in the fourth quarter and GAAP net income of $82.3 million or $2.40 per share. These results compared to revenues of $120.4 million and net income of $0.08 per share in the third quarter of 2015 and revenues of $149 million and net income of $0.36 per share in the fourth quarter of 2014.

On slide 5 we have detailed the nonoperating items included in our GAAP results for the fourth quarter and third quarter of 2015. Fourth-quarter 2015 results included a gain on the sale of energy research and a tax charge of $6.5 million to amend the capital structure of our operations outside North America. This capital structure amendment will provide continued flexibility with the movement of capital without incremental tax costs.

Excluding these items, we generated revenues of $116.5 million and a net loss of $2.5 million or $0.07 per share in the fourth quarter of 2015. For the remainder of this discussion all references to results, revenues and costs will be on an adjusted basis excluding these items.

Slide 6 presents our consolidated results along with separate breakdowns of the results from our North American and Europe and Asia Pacific operations, as well as our corporate activity. As reminder, corporate activity includes investment income and other gains as well as costs not associated with operating ITG's regional and product group business lines, including, among others, the costs of being a public Company, intangible asset amortization, interest expense, the costs of maintaining a global transfer pricing structure and foreign exchange gains or losses.

On a year-over-year comparative basis, consolidated revenues were down $32.5 million while consolidated expenses were down $11.6 million. Our consolidated pretax margin was negative 2.6%, down from 4.8% in the third quarter of 2015 and down from 11.9% in the fourth quarter of 2014.

The effective tax rate on our consolidated pretax loss was 18.9% for the quarter. Our European and Asia Pacific effective tax rate was 34%, reflecting higher rates on our European profits from legislation changes and the impact of the loss in Asia Pacific. We incurred a small tax cost in North America despite the pretax loss due to the impact of transfer price adjustments on our tax accounts and adjustments to conform to the amounts included in our 2014 file returns.

Our North American businesses posted a loss of $0.06 per share in the fourth quarter on revenues of $75.8 million and our combined European and Asia Pacific businesses posted net income of $0.08 per share in the fourth quarter on revenues of $40.4 million. Corporate activity lowered net income by $0.09 per share in the fourth quarter.

On slide 7 you can see the impact of translating the fourth-quarter 2015 income statements of our foreign subsidiaries to U.S. dollars using current exchange rates as compared to exchange rates in effect in the fourth quarter of 2014. Current exchange rates lowered consolidated net income by $300,000 as compared to exchange rates in effect in the fourth quarter of 2014. You can also see the larger impact on gross revenues and expenses.

On slide 8 we break down the performance of our North American operations between the U.S. and Canada. During the fourth quarter of 2015 we generated revenues of $63.3 million with pretax margin of negative 2.4% in the US. This compares to $66 million of revenues with a pretax margin of 1.1% in the third quarter of 2015 and $81.4 million of revenues with a pretax margin of 11.7% in the fourth quarter of 2014.

The sharp drop in commission revenues in fourth quarter reflects a full quarter of lower trading activity from U.S. clients in the wake of the SEC settlement. However, we saw some stabilization in buy-side trading activity during the fourth quarter, particularly in POSIT Alert. And as a result, our overall percentage of sell-side volume dropped from 62% to 58% sequentially, while our average revenue per share rose from 40 mils two 44 mils.

Other revenues were $1 million, down from $1.4 million in the third quarter of 2015 and down from $1.3 million in the fourth quarter of 2014, reflecting in part decreases in transaction advisory and stock loan revenue. Our U.S. expenses fell 10% from the fourth quarter of 2014 due to lower absolute compensation expenses and lower transaction processing costs due to reduced volume.

Our compensation ratio was 49.2% in the fourth quarter of 2015 as compared to 46.8% in the third quarter of 2015 and 43.2% in the fourth quarter of 2014. The higher rate in the fourth quarter of 2015 primarily reflected the sharp decline of revenues relative to our fixed compensation components, as well as the need to maintain competitive compensation levels in order to retain staff.

In Canada commission revenues were down sharply compared to both the third quarter of 2015 and the fourth quarter of 2014. The decline reflects a full quarter's impact from the SEC settlement announcement as well as the impact of currency translation.

Net income for the Canadian region was reduced by $200,000 for currency translation when comparing current exchange rates to the rates in effect during the fourth quarter of 2014. Overall Canadian market volume was also weaker during the fourth quarter, down 15% compared to the fourth quarter of 2014.

On slide 9 we break down the results of our European and Asia Pacific businesses. Europe was a strong outperformer with daily value traded in the fourth quarter, up 10% sequentially and up 30% year over year while overall market activity declined relative to both those periods.

Posit hit a new market share record at 15% of total European dark trading. European margins were 14.8%, reflecting the impact of $600,000 in employee termination charges during the quarter as we continue to look for efficiencies and the impact of a high mix of sell-side trading. However, we did see a recovery in buy-side trading activity in POSIT Alert were value trading was up 10% compared with the third quarter of 2015.

Asia Pacific revenues were down 5% compared to the third quarter of 2015 and down 22% compared to the fourth quarter of 2014, pushing the region to a net loss for the quarter of $700,000. Much of the year-over-year decline is due to a drop-off in trading activity by US-based clients in the wake of the SEC settlement.

Despite the revenue decline, we experienced sequential improvement in our trading activity relative to overall market-wide trading, with our commissions down only 3% versus a market-wide decline in value traded of 19%. We also continue to build out our regional coverage with POSIT Alert, launching block crossing in India and Taiwan during the fourth quarter and bringing total POSIT trading coverage to 10 Asia Pacific markets and 36 countries worldwide.

On slide 10 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 product groups both declined on a year-over-year basis, reflecting the impact of the drop-off post SEC settlement. Revenues in both the analytics and platform groups were steady as compared to the third quarter of 2015, although platform revenues dropped on a year-over-year basis, due in part to a drop in commissions earned on transactions executed off the ITT front ends.

On slide 11 we present supplementary pretax information for our four product groups and for our corporate activity for the fourth quarter of 2015. While margins were negative for electronic brokerage and research sales and trading, the platforms and analytics groups maintained positive margins due to the recurring revenue elements of those businesses. The sequential increase in corporate costs reflects the impact of the third-quarter reversal of stock and cash compensation associated with the management changes announced in August, totaling $2.1 million.

On slide 12 have presented our U.S. volume and rate capture statistics. Our average daily executed volume was down 18% versus the third quarter of 2015 and down 34% versus the fourth quarter of 2014. As you can see on this slide, our average overall revenue capture rate per share rose on a sequential basis and was flat year over year, due to a sequential drop in the percentage of sell-side volume and also modest increases in the average revenue per share for both our buy-side and sell-side clients.

On slide 13 we present details on our cash position. We entered the quarter with $330.6 million of cash and cash equivalents on our balance sheet, up from $166.6 million at the end of the third quarter, due primarily to $111.2 million in net proceeds from the energy research sale received in late December, after deducting cash paid for direct transaction costs and cash included in the entity sold. We also had a reduction cash required for settlement activities and clearing deposits.

We expect our cash balance to decline in the first quarter of 2016 as we make tax payments related to the gain and certain restructurings we have completed and as we pay incentive compensation for the 2015 year. Our excess cash at December 31, over and above what we need for these tax and compensation liabilities and for required respiratory capital, was approximately $110 million, up from $15 million at September 30, 2015.

We also recently renewed our $150 million credit facility that provides liquidity to backstop our U.S. brokerage operations to satisfy clearing margin requirements where necessary. While this facility cannot be used for other purposes, it allows us to maintain flexibility with excess cash on hand and cash generated from operations to fund strategic investments and capital returns.

On the next slide we provide details about our free cash flow and our capital returns to shareholders in 2015. With regard to capital returns, we were again active with our stock repurchase program in the fourth quarter of 2015, buying back 561,000 shares for $10.3 million. Since the beginning of 2010 our buybacks have reduced shares outstanding net of issuances by more than 24%.

You can recall that for 2015 our capital return guidance called for a combination of share repurchases and dividends amounting to $15 million more than our free cash flow, which under our definition, is calculated as GAAP net income increased by non-cash stock-based compensation and depreciation and amortization and reduced by capital expenditures and capitalized software. We returned $49.1 million to stockholders in the form of share buybacks and cash dividends in 2015 which is $19.4 million in excess of our 2015 free cash flow, excluding the energy sale gain and the tax charge, both of which were realized at the very end of the fourth quarter.

We are not establishing a capital return target for 2016 at this time. However, we intend to maintain a regular quarterly dividend program and we expect to be active with our share buyback program on an opportunistic basis, depending on market and business conditions and subject to any corporate activity which may necessitate alternative uses of capital.

On slide 15 we break out the expected impact of the Energy Research sale on our annual revenues and expenses going forward. Using full-year 2015 figures, the sale would reduce 2016 recurring and other revenues by approximately $20 million, while we would still be generating approximately $9 million in commission revenues from institutional clients paying for the Energy Research through trading.

On the expense side, our telecom and data costs will increase by approximately $6 million as the reduction in costs for data previously used in that business will be more than offset by licensing fees paid to RS Energy, the Warburg portfolio company, in order to continue distributing the research to our trading clients. But even factoring this in, overall expenses were dropped by approximately $6 million due to the declines in comp and benefits, occupancy and equipment and other G&A.

Looking forward, I would like to offer the following observations: Our U.S. average daily volume for January 2016 was approximately 159 million shares with average revenue per share in line with our fourth-quarter 2015 average. U.S. POSIT Alert average daily volume in January was 50% above fourth-quarter 2015 levels while average trade size increased 10%.

The average daily commissions in January in our Canadian, European and Asia Pacific businesses increased a combined 5% compared to the fourth quarter of 2015. In addition, POSIT in Europe set another market share record in January. And with that, I'd like to turn it back over to Frank.

Frank Troise - *Investment Technology Group Inc - CEO & President*

Thank you, Steve. By way of background, I most recently worked at JPMorgan where I led execution services, a global business covering execution products in equities, futures and options, FX, rates credit and commodities. Over the past 25-plus years I've had the good fortune to serve in a number of management and functional roles, including strategic planning, product management, sales, the management of technology and corporate development. And you should know that from 1997 to 2005 I was proud to call ITG home, serving as managing director responsible for client site sales and trading in my last capacity.

Over the course of the coming months I'll partner with ITG's executive committee and other leaders throughout the firm to perform an end-to-end review of our business, clients, products, people and processes. A significant amount of my next several weeks will be spent listening to clients and discussing opportunities for greater focus and engagement.

My objective is to optimize and extend many of the already impressive capabilities ITG has today to serve our current and future clients better and deliver greater shareholder value. This body of work will be critical to guiding our future investments, both organic and inorganic. I plan to share this review with all of ITG and our shareholders no later than July, in time for our second-quarter earnings call.

In less than one month it is already clear to me that there are multiple opportunities for ITG to grow scale which is driven by the lever of technology. At a high level, we'll focus on three key areas: our core equities franchise; the asset classes beyond equities; and a greater emphasis on financial technology.

First, our core business, providing execution, liquidity, platform and measurement solutions to institutional clients. We believe that we have meaningful growth opportunities ahead. Industry trends such as the unbundling of research from execution, a greater focus on measurement and further global adoption of electronic trading are winds at our back.

Second, we will extend our competencies into additional asset classes, FX, futures and credit, to name a few. ITG has made some progress in these areas and we will focus our resources on commercial and practical opportunities. Specifically, in foreign exchange investors are greatly interested in better understanding execution costs and are adopting alternative execution tools. We will leverage our TCA, execution and platform solutions to provide scalable products that are valued by our clients to capture this market.

In fixed income, especially corporate bonds, clients are concerned about the potential lack of dealer liquidity. Many are interested in, and some are experimenting with, new workflow tools and nontraditional liquidity pools which again plays to our strengths in measurement, platforms, execution and liquidity.

Our third key opportunity, we are a world-class financial technology provider. Technology is the driver of scale and it's at the heart of everything we do. We will continue to emphasize these capabilities.

It is clear that the opportunity set for ITG is sizable. I am confident our skilled team, combined with the right vision and a culture with a relentless focus on client service, integrity and management rigor and discipline, will make this Company the best it has ever been. Additionally, we have the backing of a strong Board of Directors, with a new Chairman, Minder Cheng, who is a well-respected buy-side professional. And the addition over the past several months of three distinguished new Board members: Brian Cartwright, former SEC General Counsel and veteran legal advisor; Lee Shavel, former CFO of NASDAQ, with deep industry M&A experience; and Jarrett Lilien, who provided crucial stability to ITG by stepping in as interim CEO and who is now heading up our capital committee. I am very much looking forward to partnering with this team.

Finally, as Steve discussed, we now have a strong balance sheet. We will evaluate opportunities to put this capital to work to improve profitability and generate strong returns for our shareholders. I look forward to working with all of my colleagues at ITG, some familiar faces in many new ones, as we build on ITG's proud three-decade legacy to continue to ramp up client momentum and deliver sustainable margin improvement. With that, I'll turn it over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Rich Repetto, Sandler O'Neill.

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

Good morning and welcome, Frank, and good morning, Steve

Frank Troise - *Investment Technology Group Inc - CEO & President*

Thank you

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

I know you're just here since January 15, but we are anxiously waiting the strategic review. But one of the pressing things, if you look at on the research side, even with the numbers I believe -- we haven't been able to run the new numbers that Steve just gave us, but the research would be in a loss -- it appears to be still in a loss position. Can you talk about what the opportunities are? Is that a high priority or will we wait til the complete review in dealing with the losses in that segment?

Frank Troise - *Investment Technology Group Inc - CEO & President*

As Steve mentioned earlier, from a financial perspective the Energy Research sale was a great result and we are now well-capitalized for growth. With respect to the other research sectors, they're quite valuable and through this business review we'll be taking a close look at how best to leverage them. So I would ask you for a little patience there and to come back to you on following calls.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Just to follow-up, Rich, with regard to ongoing profitability, just note that the numbers we publish publicly for that product group is on a fully-allocated basis and does not really reflect the direct contribution of the specific research assets. Additionally, we strongly believe there are opportunities to further optimize the remaining research business, as well as the other assets in that group, including our single stock and portfolio trading operations.

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

I didn't understand further optimize. I don't know what you mean by further optimize.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Improve.

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

Okay. And another question, a follow-up, would be on some of the volumes that you just reported for January, and again I haven't had a lot of time to go through, but it looks like it lags certainly the $159 million lagged about a 30% increase in consolidated volume. That speaks to the question of the efforts on client retention and on bringing back customers. Can you give us a little bit more color and detail on that because at least that number isn't showing material improvement, not from December.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Yes. In terms of growth share, recognize January was extraordinarily volatile and market share can bounce around a little bit during periods of extreme volatility and sometimes get routed away from nondisplayed pools. With regard to our recovery, Rich, the good news here is that almost all the clients that had paused trading with us in the wake of the SEC settlement have come back. There's only, I would say, less than 5% that we've still got to work on to get actually back up in live trading. All the others have gone through the process and have in fact turned us back on and are active with us.

However, I do want to say and as you can see in the market share, there's still a lot of work to do to get those clients back to the levels they were prior to the SEC settlement. So again, while they are back on, we need to continue to work and it's going to be a process to get them to be fully back on to where they were before the settlement.

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

Got it, okay. And then just one last cash question. Steve, you talked about, I think the tax payment on the gain for Ross Smith will be in 1Q. Is that correct? And it is about $30 million or somewhere around there?

Steve Vigliotti - *Investment Technology Group Inc - CFO*

No, overall we expect tax payments to be in the first quarter to be a little under $20 million

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

Okay. Thank you very much and appreciate the info.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

Thanks, Rich.

Operator

Ken Worthington, JPMorgan.

Ken Worthington - *JPMorgan - Analyst*

Hi, good morning. I think these will be on a similar theme. In terms of getting ITG back on solid footing, where is the low-hanging fruit? Or maybe is there low-hanging fruit? Like where you get the most benefit with the least amount of resources expended? And in terms of the low-hanging fruit, how far does that actually get you?

Frank Troise - *Investment Technology Group Inc - CEO & President*

Ken, we are going to continue to focus on revamping and building up our client business as we have been over the fourth quarter and through January. That to me is the key focus of our efforts. Additionally, through the business review we're going to be taking a look at everything. We're going to take a look at expenses. We're going to be taking a look at growth opportunities. And to me, three weeks in the seat is too early to really give you some color on that.

Ken Worthington - *JPMorgan - Analyst*

Okay. And you mentioned the -- or Steve mentioned -- firms are taking ITG off the do-not-trade list. And obviously that's first step. What is the pathway of once they take you off the do-not-trade list, how do you and how long does it often take to get clients to trade back towards the same level that they had prior to cutting ITG off? Is it three months, is it nine months, is it forever? How long is there a good rule of thumb?

Frank Troise - *Investment Technology Group Inc - CEO & President*

I don't know if there's a specific play book for this. We're going to work as hard as we can to continue to engage with our clients, rebuild their trust and hopefully work with them to restore levels with us.

Steve Vigliotti - *Investment Technology Group Inc - CFO*

It's independent, client by client. It's a process and each client has to go through their process.

Ken Worthington - *JPMorgan - Analyst*

Okay.

Frank Troise - *Investment Technology Group Inc - CEO & President*

It's one that we haven't had experience with in the past.

Ken Worthington - *JPMorgan - Analyst*

Okay. If things go more slowly in terms of the client recovery, how do you start to think about managing the expense size to right-size the cost with the revenue? How are you thinking about that?

Frank Troise - *Investment Technology Group Inc - CEO & President*

Ken, I'm interested in growth and I'm a firm believer in the business adage of the quickest way to grow is to stop shrinking. That said, anyone who knows me will tell you I'm a stickler for expense control. And if there are areas where we can operate in a leaner, more efficient fashion, we're going to seek them out. We'll find them and we'll make the necessary changes. Costs will be evaluated in the near-term as part of our end-to-end business reviews.

Ken Worthington - *JPMorgan - Analyst*

Okay. But it sounds like the real focus is not on costs initially, you're there to grow it.

Frank Troise - *Investment Technology Group Inc - CEO & President*

Correct.

Ken Worthington - *JPMorgan - Analyst*

Okay, great. Thank you very much

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Frank Troise for any closing remarks.

Frank Troise - *Investment Technology Group Inc - CEO & President*

Thank you for joining us today. I am excited to be back at ITG and I'm confident that the best is yet to come for our clients, our shareholders and our employees. I look forward to meeting with many of you in the coming months and to speaking with you again on our first-quarter earnings call in May.

Operator

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