Interactive Brokers Group's (IBKR)

Q2 2023 Results - Earnings Call Transcript

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Executives

Thomas Peterffy - Chairman

Milan Galik - President, CEO & Director

Paul Brody - CFO

Nancy Stuebe - Director, IR

Analysts

Ben Budish, *Barclays*

Craig Siegenthaler, *Bank of America Merrill Lynch*

Daniel Fannon, *Jefferies*

Patrick Moley, *Piper Sandler*

Chris Allen, *Citi*

Kyle Voigt, *KBW*

Operator

Good day, and thank you for standing by. Welcome to the Interactive Brokers Group Quarter Two 2023 Earnings Call. (Operator Instructions) I would now like to hand the conference over to Nancy Stuebe. Please go ahead.

Nancy Stuebe

Thank you. Good afternoon, and thank you for joining us for our second quarter 2023 earnings conference call. Once again, Thomas is on the call, but asked me to present his comments on the business. Also joining us today are Milan Galik, our CEO, and Paul Brody, our CFO. After prepared remarks, we will have a Q&A.

As a reminder, today's call may include forward-looking statements, which represent the

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

Our robust operating metrics once again translated into strong financial results this quarter. In fact, but for a substantial addition to reserves for legal contingencies, we would have posted record adjusted pretax income. Our account growth remained strong at 19%, while our client equity was up 24%. Margin loans have increased over the course of 2023 as investors are feeling more confident in the markets after a down year in 2022. Our net interest income reached a record, as did our total adjusted net revenues, which were over $1 billion this quarter.

On the other hand, trading volumes dropped this quarter and with that dropped our commissions by 10% from the first quarter. Lower commissions prevailed across the board. Option commission decreased the least, then came futures, and stock commissions dropped the most.

I do not expect this situation to reverse.

Our clients are most heavily weighted in the magnificent 7, where they luckily have huge unrealized gains that they are not likely to want to realize. As a result, I expect a lot of calls to be written in the coming quarters in these stocks. When the stocks rise further the calls will be repurchased and when they fall, they will lapse.

In this way our option commissions will benefit, and our stock commissions will continue to suffer.

Investors voted to put their money into big tech stocks rather than keeping it at banks at near zero returns.

As usual, we do not know how well our advertising worked. Telling everyone about our 4.58% return on immediately available qualified cash may have prevented more and larger withdrawals, but it barely helped to increase customer cash which grew only by a little more than 2% over the first quarter.

As I have mentioned before, I still believe inflation is going to stay with us, and while there may be a "pause" in rate hikes, this is not a short-term state of affairs that will soon result in rate cuts. The debt has increased by a trillion dollars since Congress raised the debt limit. Interest on US debt cost over $650 billion over just the past 9 months; annualized, this comes close to a trillion dollars a year. This increased spending will drive inflation, which will lead to higher rates, which will in turn increase spending, and so on.

In terms of our client segments, our strongest ones for account growth have been individuals, proprietary traders, and hedge funds. These have also shown the strongest growth in 12-month commissions revenue, while individuals, prop traders and financial advisors have been the strongest drivers of net interest income.

We are still looking to onboard the first of the two large introducing broker accounts this year, hopefully in the third quarter. It will start slowly and we hope to see it completed within a few months of its start. Our dates are slipping with respect to the second large introducing broker but we are still hoping to begin onboarding them before year end.

Our developers have been extremely busy with new products and tools, and have a full plate for the remainder of the year.

One area we have focused on is delivering specific tools to specific customer types. For financial advisors, we introduced customized indexing, making it easy to build stock portfolios modeled on ETFs that are customizable for tax efficiency and investment goals. Customized indexing clients will own fractional shares of each component stock, so the advisor can adjust weightings, capitalize on gains or losses for tax purposes, or exclude specific stocks or sectors, personalizing as their clients need. We also introduced a tax loss harvesting tool, a streamlined CRM, and now

offer our RIAs research from ISI Evercore. We do not require minimums, we have no ticket charges, and charge no custodial, technology, software, platform or reporting fees.

For individuals and introducing broker clients, we expanded overnight trading in US stocks and ETFs, and now have over 10,000 names available. This has been particularly attractive for our clients in those time zones where investing during regular US trading hours is difficult.

For our more sophisticated clients and funds, we introduced our Securities Lending Dashboard, which allows them to access the same expanded securities lending data and key metrics for US equities that, historically, were only available to banks, broker-dealers and large institutional investors.

Internationally, we added the Taiwan Stock Exchange, Nasdaq Copenhagen and the Prague Stock Exchange to our platform, while fractional share trading will soon be available for Canadian stocks and ETFs.

We remain committed to having the most informed clients, wherever they are in their investing journey. Our IBKR Campus educational website has the courses, webinars, podcasts and market commentaries to assist our clients in learning more about trading, the economy, and financial markets - from the most basic educational fundamentals to sophisticated strategies and market commentary. They can learn more about Interactive Brokers' trading tools and how to use them. Our Learn & Earn program lets clients who are new to a particular securities product earn commission credits for each bundle of courses they complete.

We remain very optimistic about what our business model – international market access, a strong and secure balance sheet, multiple features and tools, at low prices and high interest paid on cash balances – offers to clients and potential clients around the world.

We are extremely disappointed that we did not achieve a new record in the second quarter and we are determined to redouble our efforts and get there in the third.

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

Paul Brody

Thank you, Nancy. Thanks, everyone, for joining the call.

As usual, we'll start with our Revenue items on page 3 of the release. We followed on our strong first quarter performance, recording net revenues of $1 billion in the current quarter. With ongoing customer account and balance sheet growth, we continue to build a strong base for both commission and interest revenues in the future.

Commissions were $322 million, level with the year-ago quarter despite industry-wide declines in volumes for futures and especially for equities. Our futures and options volumes came in near their quarterly highs, while stock share volumes declined from last year's quarter, once again driven by a drop in trading of lower-priced stocks.

Net interest income was a quarterly record $694 million, reflecting higher interest on margin loans and segregated cash, from both increases in benchmark rates and a larger segregated cash portfolio. US benchmark rates have moved from an average effective rate of 77 basis points in the second quarter of last year to 499 basis points this quarter. These gains were partially offset by the higher interest we paid on customer credit balances, as our longstanding policy is to pass through rate hikes above 50 basis points to our customers on their qualified funds.

Other fees and services generated $47 million, with the biggest contributors being market data fees of $18 million, risk exposure fee revenue of $10 million, and options exchange liquidity payments of $7 million. The increase in risk exposure fees from the prior year quarter was driven by more risk-on positioning of customers, which led to a $4 million rise in these fees.

Other income was a loss of $63 million and includes gains and losses on our investments, our currency diversification strategy and principal transactions. Note that many of these non-core

items are excluded in our adjusted earnings, and without these excluded items, Other income was a $1 million gain for the quarter.

Turning to expenses, Execution, Clearing & Distribution costs rose 21% versus last year, led by higher volumes in options, which carry higher fees, the non-recurrence of last year's $3 million OCC clearing fee rebate, and a $1 million increase in market data fees, as well as lower liquidity rebates.

We find it useful to measure what we call Gross Transactional Profit, which is commissions less Execution & Clearing costs directly related to trading, which excludes primarily market data distribution fees. As a percent of commission revenues, Execution & Clearing costs, which are driven by a combination of trading volume, exchange rebates and changing fee schedules, were 22% this quarter, for a Gross Transactional Profit margin of 78%.

Market Data expense, a pass-through item, is included in "Execution, Clearing & Distribution Fees" line item, while the corresponding Market Data revenue is reported in "Other fees and services" rather than in Commissions. For this purpose, in the second quarter we exclude $15 million in Market Data expense.

Compensation & Benefits expense rose 21%, over the prior year quarter, on a combination of staffing increases and inflation. While up in dollar terms for the quarter, Comp & Benefits expense remained at 13% of our adjusted Net Revenues, versus 16% last year and somewhat below its historical level. Our headcount at quarter-end was 2,908.

G&A expenses roughly doubled versus last year's second quarter, largely attributable to a substantial increase in reserves related to the previously-disclosed regulatory investigation into the use of unapproved electronic messaging and the firm's record-keeping requirements. Without that increase, G&A expenses would be down slightly year-on-year.

Our adjusted pretax margin was 67%, up from 63% in the year-ago quarter. While higher interest rates benefit us, automation remains our key means of maintaining consistently high margins.

Income tax expense of $51 million reflects the sum of the public company's $30 million and the operating companies' $21 million.

Moving to our balance sheet on page 5 of our release, our total assets were $121 billion at the end of the quarter, with growth over last year driven primarily by increases in our segregated cash and securities.

We maintain a balance sheet aimed at supporting our growing business and providing ample financial resources during volatile markets, with maximum flexibility and short-term liquidity. We have no long-term debt.

The duration of our investment portfolio as of June 30th was 40 days.

Turning to our operating data, on pages 6 and 7, our contract volumes for all customers were strong, reaching their fourth highest quarterly level in options, up 9% over the year-ago quarter. Futures contract and stock share volumes were down 3% and 28%, respectively. Options and futures volumes were generally in line with industry volumes. And in stocks, the drop off was largely attributable to investors moving to higher quality stocks, as trading in pink sheet and other very low-priced stocks was impacted most.

On page 7, you can see that our account growth remains robust, with over 95,000 net account adds in the quarter, and total accounts at 2.3 million, up 19% over the prior year.

Total Customer DARTs were 1.9 million trades per day, down 14% from the stronger prior-year quarter.

Our Cleared IBKR Pro Customers paid an average of $3.11 Commission per Cleared Commissionable Order, up 14% from last year as our clients' volume mix included higher per order contributions from nearly all product categories, particularly from options and futures.

Page 8 presents our Net Interest Margin numbers. Total GAAP net interest income nearly doubled to $694 million on the year-ago quarter, reflecting stronger earnings on segregated cash and margin loans, partially offset by higher interest expense on customer cash balances. After a series of seven target rate increases in 2022, the Federal Reserve has raised interest rates by 25 basis points three times this year. Many other central banks also raised rates this quarter. This group includes the UK, Canada, Australia and Hong Kong, as well as the Eurozone and Switzerland.

Net interest on segregated cash was $700 million, primarily due to Federal Reserve rate hikes but also to our managing to short duration on invested funds, which has allowed us to more closely match asset and liability maturities and to pick up benchmark rate increases quickly. At June 30th, our US portfolio duration was 40 days, so the investments have rolled over into new, higher, rates with a fairly short lag time. A 21% increase over the year-ago quarter in average segregated cash and securities balances also drove interest income higher.

Margin loan interest rose to $547 million, up significantly from $197 million last year, despite average margin loan balances declining 11% from last year's second quarter. Higher rates, in the US and internationally, have driven higher margin interest income.

Securities lending net interest was $79 million, down from the year-ago quarter due to a dynamic we have noted previously. While securities lending opportunities maintained a relatively strong pace, it is also the case that as benchmark rates rise, a greater portion of the revenue generated by lending securities, for which we receive cash collateral that we invest as segregated funds, is reflected as interest on Segregated Cash. We estimate this impact to be about $40 million for the quarter vs last year. In other words, without this shift in reporting line items, net interest from securities lending would be $119 million, up 3% from the year-ago quarter.

Interest on Customer Credit Balances, or the interest we pay our customers, grew as higher rates in many currencies led to our paying interest on qualifying balances as we pass through rate increases. We paid $774 million to our customers on their balances in the second quarter.

Fully rate sensitive balances were roughly unchanged at about $20 billion.

We consider our policy offering clients a full pass-through of all rate hikes after the first 50 basis points on their qualified cash a significant component in our success, and one that continues to set us apart.

We believe this leads to clients choosing to keep their cash with us, especially active clients who do not want to use sweep programs that prevent them from immediately accessing their cash to invest.

Now, for our estimates of the impact of increases in rates – given market expectations of possibly one or more rate hikes to come, we estimate the effects of increases in the Fed Funds rate to produce additional annual net interest income of approximately $49 million for each 25 bps increase in the benchmark. Note that our starting point for these estimates is June 30th, with the Fed Funds effective rate at 5.08%, and based on balances at that date. About 25% of our customer cash balances is not in US dollars, so estimates of US rate change effects exclude these currencies. We estimate increases in all the relevant non-USD benchmark rates to produce additional annual net interest income of $26 million for each 25 basis point increase in the benchmarks.

In conclusion, the company performed well in the second quarter in a complex and uncertain environment, reflecting our continued ability to grow our customer base and deliver on our core services to customers, all at low cost and while offering meaningful cash interest, as we manage the business effectively with strong controls over risk and operating expenses.

And with that, we'll turn it over to the moderator, and we will take questions.

Question and Answer Session

Operator

(Operator Instructions) Our first question is from Benjamin Budish of Barclays.

Ben Budish

Maybe first on the marketing spend. You indicated it's not entirely clear if it's working the way you hoped. Can you maybe talk about kind of your commitment to continuing with that? And maybe for Paul, just I think you had previously indicated that there would be a bit of a step-up quarter-over-quarter, but when we sort of subtract the reserve charge that you took, it looks like the step-up maybe wasn't as big. So how much of that spend was in the quarter? And what are your thoughts on sort of continuing with that strategy?

Thomas Peterffy

Are you asking about marketing expenses or the reserves?

Ben Budish

The marketing expense. So, I think if you back out the expenses.

Thomas Peterffy

The marketing expense-- yes, we are definitely going to stick with our marketing programs, and we will increase marketing spend gradually - quarter after quarter after quarter, we will spend more and more money marketing. As we find out marketing outlets that we believe to be, although we cannot precisely measure it, but we believe to be a positive impact.

Ben Budish

Got it. That's helpful. And then maybe, Thomas, just to kind of pick your brain on the sort of the customer trading behavior. What do you -- it sounds like you're expecting things to be a little less active in the back half of the year. What do you think kind of reverses that? Is it sort of a decline in rates? Is it just more broader macro volatility? What sort of indicators should we be looking for maybe like with your unique customer segment that might drive more of a pickup there?

Thomas Peterffy

Well, I think that what is coming down the pike is more technology-driven order flow. And that, as more AI systems get behind money management, I think that as a result of that-- trading activity will pick up. There will be more and more small orders. There will be more and more

fractional shareholders. There'll be more and more registered investment advisers who will hire technology-driven systems to drive their investment choices. And so that's what I see in the future.

Operator

Our next question comes from Craig Siegenthaler of Bank of America.

Craig Siegenthaler

I wanted to get an update on your prospecting effort in the introducing broker channel and really trying to gauge the potential to translate some of these prospects into IBKR customers. And maybe one thing you can share with us, if you can, is like how many prospecting meetings you have done in the first half of the year.

Milan Galik

Introducing brokers have always been an important segment for our business. That is what our sales force focuses on. We have many prospects in the pipeline in various stages of development. With some, we are still discussing the best way to connect and integrate with us. Others are already doing test trades on our platform, and the most advanced ones are already at the stage of getting their customers into production trading.

Not much has changed other than we continue to focus on the i-broker segment, and we are continuously making software development changes that make the integration easier, so that we can offer them more choices for the integration going forward.

Craig Siegenthaler

So, my follow-up is, given slowing growth on a cyclical basis in the active trader channel relative to accelerating growth in the introducing broker vertical, can you talk about how you expect this to impact your profitability or even revenue growth relative to account growth?

Thomas Peterffy

Yes. So look, the introducing broker client is always the least profitable client. The hedge fund client is always the most profitable client. And the prop traders are our sweet spot. So yes, to the extent that our number of accounts will jump in number the profitability will not similarly increase. Profitability comes mostly from our more sophisticated professional client base - which is, by the way, also is increasing quite well.

Operator

Our next question comes from Daniel Fannon of Jefferies LLC.

Daniel Fannon

I was hoping to follow up on that and just think about maybe you get a sense of the activity levels, or how active you think the introducing broker relationships are when they come on board and the maturation to think about other customers, I think you've talked about previously, as they get comfortable with the platform and they trade more over time. Is that still similar when you think about the IB channel? And is there a way to put some numbers around that?

Thomas Peterffy

Well, put some numbers around it. Well, let me put it this way. So, our average account yields about $1,200 of revenues per year. The average introducing broker account, I'm guessing here. The average introducing broker account, I would expect them to be around $300 to $400 a year in commissions. I mean you're asking the numbers around it. I do not have these numbers in front of me, unfortunately. So, really -- I'm embarrassed I can't tell you.

Daniel Fannon

Understood. That's okay. I guess a more specific modeling question for Paul. Just in terms of the other income, it's moved around a lot in recent quarters is $1 million when we adjust everything out. What's a reasonable level or as you think about like a baseline level going forward to model for?

Paul Brody

Well, I think it's not that variable. When you take out our non-GAAP adjustments, right, which is primarily the currency impact and partially from mark-to-market on the U.S. government securities. And by the way, that's smaller than it used to be, given that our duration is so short.

So, we report to you which items we've taken out. And if you take those out, you probably get a reasonable baseline. But other income is also some miscellaneous investments and things that are not very predictable. But after those large items, the whole category is not very large.

Operator

(Operator Instructions) Our next question comes from Patrick Moley of Piper Sandler.

Patrick Moley

Just one on last quarter, you had the security sale. Just wondering if you could quantify the impact from that reinvestment had on net interest income in the current quarter.

Paul Brody

I don't think we could say that precisely. You're talking about when we liquidated some treasuries, reinvested them in shorter term.

I mean we recognize the liquidated loss and obviously reinvested at short-term current treasury rates. And if you look at the yield curve, you know what those are? So yes, we're making it back for sure.

Operator

Our next question comes from the line of Chris Allen of Citi.

Chris Allen

I had a couple of follow-ups. On the other income, is there any legacy market making still left in there? I know there was when you had sold the business, and that's where it got recorded and

drove some principal transactions. Is that still on that other income line?

Paul Brody

It's still in there, and it's a very minor contributor to the total.

Chris Allen

Understood. And then just on the duration of the U.S. investment portfolio. You know it was 40 days. If I recall correctly, last quarter, you sold some securities and reinvested and I think the duration was 24 days. So based on those numbers, seems like you're extending a little bit. Obviously, nothing crazy or anything like that. Do I have that correct? And was this a function of any extension? Or is it just a function of maybe stuff maturing and new cash coming on?

Thomas Peterffy

Well, it all has to do with when the Fed is scheduled to move. So, we do not want to speculate on what the Fed is going to do. So, we like to prefer to -- invest before the Fed date or if the Fed like in this case, said that they are going to raise a quarter. We believe them that they are going to raise a quarter, and given that the market believes 98% that they are going to raise a quarter, we don't mind to go over that date, but not the subsequent date. So, we are still before - we are investing prior-- our investment will mature before the September Fed meeting.

Operator

(Operator Instructions) Your next question comes from the line of Kyle Voigt of KBW.

Kyle Voigt

Maybe just a question on the compensation expense. So, the headcount was up, I think, roughly 5% year-on-year, comp looks up closer to 20%. I just want to make sure that there were no one-offs, Paul, in the comp line or anything to know from a one-off standpoint. And also, I just wanted to clarify the entirety of the kind of one-offs and legal reserves that were in the G&A line specifically?

Paul Brody

Right. So, on the comp -- and you're right to ask this question. So, it's not specifically a one-off, but there is some extra expense in there for -- we have to expense accrued vacation days of staff that have not yet been taken. So, each quarter, we measure the accruals, which are at a fairly consistent rate versus days taken, and they tend to be smaller in the second quarter and then people tend to take vacation in the third quarter. And each quarter, we have to recognize an expense of the difference between those two.

It happened to be that in the second quarter, the difference was larger than usual. And so there is -- probably the impact is 2% or 3% on that 21% that came from that, we would expect it to return maybe even in the third quarter, depends on when people take a vacation. And then, of course, inflation figures into all of that, and we had a headcount increase. So that gets us to most of the rest.

Kyle Voigt

I guess when you're thinking about this year versus last year, I guess we're hearing from some others that maybe the hiring environment is getting a bit better. They're seeing a little bit less inflation in terms of staffing costs, a less and less competitive environment.

I guess when we look at your 2022 figures, it seems like there's maybe a little bit less inflationary pressures, I guess, relative to the headcount that you grew in 2022. It seems to be more of a divergence this year, but I know there's other factors in there. So just wanted to know if you could kind of maybe parse out what you're seeing from a hiring standpoint. Are you having to pay up to retain employees, et cetera, kind of what's really driving that? And how the environment maybe has changed from 2022 to 2023 on the inflationary side?

Milan Galik

In 2022, at the end of the year, when we pay our employees their bonuses and adjust their base salaries for the next year, we had to award significant increases in response to the inflation. At the beginning of this year, we thought that we were going to have an easier time hiring, especially the tech people after the layoffs were announced by the big tech companies. That unfortunately did

not last long.

Very recently, let's say, the last month, we have had occasions where we had made what we thought to be competitive offers to some information technology applicants, that were declined. So there are lots of jobs out there, again, especially in the tech area, and we have to pay attention and we have to pay what it takes to get the talent in the door.

In this last quarter, we managed to hire, we have net 36 more employees than the quarter before. Approximately half of them are in the technology space, the rest of them are in client services and compliance.

Kyle Voigt

That's great color. And I guess, does that change your view or inform your opinion as to like how we should think really about those - the fixed expense growth for the business. I think in the first quarter, it's trending towards 10% seems, I think it was closer to 15% when we kind of back out the legal expense in the second quarter.

I guess, is there a right - kind of in the environment that we're in today - is there a right way to think about that kind of total fixed expense growth as we look ahead over the next, let's call it, 18 to 24 months?

Milan Galik

I think 1 measure that you could use would be the core inflation rate, and we do not want to stay behind. We want our employees to maintain their standard of living. We want to remain competitive so that we have significant talent in our offices, helping us build our systems for the future.

So, to the extent that the inflation stays with us or increases, we are going to be responding to that, just like to market forces, if the competing companies pick up their hiring, and we will have to compete for the talent, we will do so. We are a technology company at its heart, and we will

always spend what we need to, to make sure that we have the right people building our systems.

Kyle Voigt

Understood. I just want to ask one more question given we're at the end of the call here, towards the end. Just on margin balances - I know those rose month-on-month in June to $42 billion. But the margin balances are still significantly below the $55 billion peak that was reached in, I believe, December 2021.

So, first part of the question, just given the risk-on environment, we're continuing to see in July, is it fair to think those margin balances have continued to increase month to date? And then the second question, like do you have any view as to how much of the decline in margin balances from that December 2021 peak to current levels was driven by the risk-off environment, and the shift that we saw over the last year versus higher borrowing rates, because we're just trying to get a sense of maybe how much room there is to run in terms of margin balance increases if this risk on environment persists from here?

Thomas Peterffy

So, margin balances are increasing, and they have increased since the end of the quarter. And look, as long as the market keeps creeping up, margin balances will continue to creep up along with it. What happens with us is that any time there is a sudden fall in the market, people immediately sell out their leveraged positions, and then they become very careful and use lower leverage going forward. So all I have to say to you is that as long as the market keeps going up, our margin balances will continue to rise.

Operator

I am showing no further questions at this time. I would like to turn the conference back to Nancy Stuebe for closing remarks.

Nancy Stuebe

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

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.