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MKTX - Q4 2011 MarketAxess Holdings Inc. Earnings Conference Call

EVENT DATE/TIME: FEBRUARY 01, 2012 / 3:00PM GMT



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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. (Operator Instructions). As a reminder, this conference is being recorded Wednesday, February 1, 2012.

I would now like to turn the call over to Dave Cresci, Investor Relations Manager at MarketAxess. Please go ahead sir.

Dave Cresci - *MarketAxess Holdings Inc. - IR Manager*

Good morning. Welcome to the MarketAxess fourth-quarter 2011 conference call.

For the call, Rick McVey, Chairman and Chief Executive Officer, will review the highlights for the quarter and will provide an update on trends in our businesses, and then Tony DeLise, Chief Financial Officer, will review the financial results.

Before I turn the call over to Rick, let me remind you that today's call may include forward-looking statements. These statements represent the Company's belief regarding future events that, by their nature, are uncertain. The Company's actual results and financial condition may differ materially from what is indicated in those forward-looking statements. For a discussion of some of the risks and factors that could affect the Company's future results, please see the description of risk factors in our annual report on Form 10-K for the year ended December 31, 2010. I would also direct you to read the forward-looking disclaimers in our quarterly earnings release which was issued earlier this morning and is now available on our website.

Now let me turn the call over to Rick.

Rick McVey - *MarketAxess Holdings Inc. - Chairman, CEO*

Good morning and thank you for joining us to discuss our 2011 results. This morning, we reported our fourth-quarter financial results, capping off a year of strong revenue and earnings growth.

Revenue of \$45.1 million was up 17% from a year ago and pretax income of \$18.9 million was 31% above the fourth quarter of 2010. Diluted EPS improved to \$0.29 compared to \$0.23 one year ago. These results were achieved in spite of softer industry trading volumes during the quarter. In



addition, the failure of MF Global during the quarter resulted in lower distribution fees of approximately \$400,000, and higher expenses of approximately \$950,000 due to the full write-off of MF Global receivables.

Total trading volume was \$125 billion, up 20% from a year ago, driven by strong gains in market share. Our estimated high-grade market share reached 12.2% in the fourth quarter of 2011, up strongly from 9.6% in the fourth quarter of 2010. Increases in investor order flow continue to drive these market share gains.

Slide 4 displays some details on our annual results and financial strength. Strong year-over-year revenue growth, coupled with moderate expense increases, continue to drive record annual earnings. Since the credit crisis in 2008, we have reported three consecutive years of revenue growth in excess of 20% and EPS growth in excess of 50%.

EBITDA was up 49% to \$86 million for 2011. Operating and EBITDA margins of 44% and 47% respectively again hit record levels in 2011. Incremental margin for the full year was 80%.

In light of the strong growth in earnings, and free cash flow of almost \$60 million in 2011, our Board of Directors has declared an increase in the regular quarterly cash dividend to \$0.11 per share from \$0.09.

Our cash and securities balance at December month end was \$248 million, or \$6.22 per diluted share. We spent \$6.9 million to repurchase shares in the fourth quarter under the \$35 million share repurchase program.

Slide 5 provides an update on market conditions. An increase in credit spreads and credit spread volatility combined with a further decline in primary dealer balance sheets led to an overall decline in TRACE volumes during the fourth quarter. We believe the European debt concerns weighed heavily on the market, causing an overall reduction in risk appetite for credit.

Market conditions in both the US and Europe have gotten off to a much better start in early 2012 following the introduction of the ECB long-term refinancing operation. Spreads have moved tighter and secondary volumes are on pace with the record first quarter of 2011.

We expect to release our January trading volumes later this week once the FINRA TRACE volumes have been finalized. Those results will show a new record for monthly average daily trading volumes. Our US high-grade estimated market share will be below the December and fourth-quarter 2011 levels following the normal seasonal pattern. The reduction in primary dealer balance sheets is leading to lower average trade sizes in the corporate bond market and a lower percentage of TRACE volume in block trade sizes.

Investors continue to seek out alternative sources of liquidity, leading to an increase in trades done with new dealer counter-parties. These market changes, combined with new regulatory initiatives, continue to support greater electronic trading in credit markets.

Slide 6 highlights our improved client and dealer participation. The increase in trading connections on the MarketAxess system is allowing dealers and investors to find unique trading opportunities. Investor order count reached a new record during the quarter in spite of the fact that TRACE high-grade volume was down 13% from the third quarter.

New dealers added to our system since the third quarter of 2008 accounted for approximately 28% of the trading by count and a record 21% of trading by volume during the fourth quarter, representing an important addition of liquidity for investors. Our transaction cost savings estimates show a meaningful reduction in investor execution costs on MarketAxess versus phone-based trades on TRACE.

The decline in hit rates or percentage of orders resulting in a trade reflects the more challenging market environment over the second half of 2011. We have seen an increase in hit rates with the improved market conditions in January.

Slide 7 summarizes the trading volume across our product categories. Full-year 2011 global volume was \$525 billion, up 31% over 2010. Overall global volume in the fourth quarter was up 20% year-over-year to \$125 billion. Despite a 7% decline in TRACE volumes from year-ago levels, our US high-grade volume was \$75 billion, up 19% year-over-year.



Eurobond volumes were down 25% from the fourth quarter of last year, continuing to reflect the uncertainty in the region's markets. By contrast, European clients trading of US high-grade and emerging market instruments on MarketAxess rose strongly during last year, and was up over 40% from 2010 levels. We are confident that we can grow Eurobond volumes longer-term, and we will reduce our Eurobond monthly dealer distribution fees by 50% effective March 1, in recognition of the difficult trading conditions and current level of investor flows in this category. In January, we have seen a rebound of Eurobond volumes from weak second-half levels.

The Other product category volumes increased to \$42 billion in the fourth quarter, up 38% from a year ago with the strongest growth coming from our agency product. For the full-year 2011, trading in our Other product category was up 52% with strong growth across all three main products -- emerging markets, high yield, and agencies.

CDS trading is our single largest investment area, and regulatory delays aside, we believe we are well positioned to capitalize on the electronic trading of swaps. The CFTC and SEC have pushed the expected SEF rules finalization beyond the first quarter of 2012. These delays would suggest that implementation dates are now likely to come toward the end of 2012.

Now let me turn the call over to Tony for more detail regarding our financial results.

Tony DeLise - MarketAxess Holdings Inc. - CFO

Thank you Rick.

Please turn to Slide 8 for some perspective on our full year results. The 2011 performance highlights the operating leverage in our business. Compared to 2010, revenue was up 24% and pretax income was up 55%.

Operating margin for the full year expanded to 44%, up strongly from 35% in 2010. \$0.80 of every additional revenue dollar we earned in 2011 versus 2010 fell directly to pretax income.

Overall US high-grade TRACE volumes were flat again in 2011. The majority of the revenue increase was derived from market share gains and the positive distribution fee impact from dealers migrating to the major US dealer fee plan.

Slide 9 displays our quarterly earnings performance. Revenues of \$45.1 million were up 17% from a year ago, driven principally by trading commission growth. Total expenses were \$26.3 million, up 9% from both the fourth quarter of 2010 and sequentially from the third quarter. Fourth-quarter expenses reflect several one-time charges aggregating \$1.5 million, which I will cover momentarily.

Pretax income was \$18.9 million in the fourth quarter, up 31% from last year. Our effective tax rate for the fourth quarter was approximately 39% and consistent with our full-year tax rate.

Our diluted EPS was \$0.29 on 39.8 million diluted shares. Buybacks under our share repurchase plan were initiated in mid-December and had a minor impact on the fourth-quarter diluted share count.

On Slide 10, we have laid out our commission revenue, trading volumes, and fees per million. Distribution fees were \$16.8 million during the fourth quarter of 2011, up 25% from the fourth quarter of 2010.

As expected, during the fourth quarter, two additional dealers moved to the major plan. The impact of this movement in the US was offset by the loss of MF Global, a dealer on the major US high-grade plan.

As Rick mentioned, we'll be reducing our Eurobond distribution fees by 50% effective March 1. We expect that Eurobond distribution fees will decline by approximately \$450,000 per month.



In addition, two dealers in the US have or will be migrating off of the major US high-grade plan. Absent any other changes compared to the fourth-quarter level, distribution fees are projected to decline by approximately \$1.2 million in the first quarter of 2012.

US high-grade fees per million were \$190 in the fourth quarter and consistent with the third quarter and prior year. Our US high-grade variable transaction fees are dependent in part on the individual trade size. The expected decline in fee capture resulting from the two dealer migrations to the major plan at the beginning of the fourth quarter was offset by a shift in mix favoring smaller trade sizes.

The Other product category fee captured decreased from \$175 per million in the third quarter of 2011 to \$166 per million in the fourth quarter. The sequential and year-over-year decline in fees per million was due to product mix shift.

Slide 11 provides you with the expense detail. Total expenses for the fourth quarter were \$26.3 million, up 9% from a year ago. The full-year 2011 expenses of \$102 million were in line with the updated guidance we provided in October, but there were several items of note during the fourth quarter. We recorded a 100% reserve against accounts receivable due from MF Global, and a write-off of a minority investment. These two charges totaled \$1.5 million or \$0.02 per diluted share in the aggregate.

Also during the fourth quarter, we adjusted the incentive bonus provision downward which resulted in lower-than-anticipated compensation and benefits expense. The final 2011 bonus provision of \$20 million represented a 13% increase over the 2010 level.

On Slide 12, we provide balance sheet information. Cash, cash equivalents, and securities available for sale as of December 31 were \$248 million compared to \$198 million at year-end 2010 and \$238 million at September 30, 2011.

We spent \$6.9 million in the fourth quarter on the share repurchase plan.

As a reminder, we believe that available unrestricted federal tax loss and credit carryforwards have now been exhausted. Carry-forward availability reduce our federal tax liability by approximately \$13 million in 2011.

We expect an increase in cash paid for income taxes in 2012 and subsequent years. We currently expect the balance of the share repurchase plan will be completed over the next several months. Assuming we complete the plan as scheduled and our share price remains stable, once completed, we expect our diluted share count to be approximately 38.8 million. We also anticipate that, when completed, the buyback will add approximately \$0.01 per diluted share in quarterly earnings. There was no change in our capital structure during the fourth quarter, and we continue to have no bank debt.

On Slide 13, we have our 2012 expense, capital expenditure, and income tax rate guidance. We expect that total expenses will be in the range of \$107 million to \$112 million. The midpoint in that range is consistent with our five-year compound annual growth rate in expenses of approximately 6%. We anticipate that expenses will show a modest sequential ramp throughout 2012.

Capital expenditures include computer software and equipment, together with capitalized software development costs associated with trading platform enhancements and new products. The anticipated increase in our CapEx spending in 2012 is due to an expected buildout of a new disaster recovery site.

We expect that the effective tax rate for full year 2012 will be between 39% and 41%. Among other items, the mix of US and foreign sourced income and changes in tax rates could cause variations in the effective tax rate.

Now let me turn the call back to Rick for some closing comments.

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

Thank you Tony. We are pleased to report another very strong year for revenue and earnings growth. We believe that market structure and regulatory changes are driving a demonstrable increase in demand for electronic trading in credit markets.

In addition to our strong competitive position in core products today, we are investing actively in new product areas. Our revenue growth is allowing us to invest in new products, grow earnings, and return more free cash flow to our investors through dividends and share repurchases.

I would like to thank our employees for their dedication to serving our customers again in 2011. We expect 2012 to be another exciting year for developments in the e-trading space.

Now I would be happy to open the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Howard Chen, Credit Suisse.

Howard Chen - Credit Suisse - Analyst

Good morning Rick. Good morning Tony. Just question on -- (inaudible) Howard Chen. Tony, just on the expense guidance, I hear you on the sort of consistent growth rate over the last five years. But given that the midpoint is a good bit above second-half run rate last year, could you give a little more detail on which kind of line items you expect an increase in expenses?

Tony DeLise - MarketAxess Holdings Inc. - CFO

Sure. I'd be happy to. On that expense guidance -- and again, in the prepared remarks, I mentioned that the midpoint was consistent with our five-year compound annual growth rate. When we look at expenses, around 60% of our expenses consistently come from the compensation and benefits line. That line probably more than any other line in our income statement, that's where you're going to see the growth in expenses. It won't be an immediate growth beginning in the first quarter. There will be some ramp up throughout the year, but that is the single biggest line where you will see expense growth.

The second biggest line where you are going to see expense growth is in the depreciation and amortization line. If you look at all of our other expenses, those are expected really to be flat. On the depreciation and amortization line, we do have some expenses there associated with our data center buildout. Some of that depreciation will hit in 2012.

Even when you look at our capitalized software development spend, particularly in 2011 and what we expect to capitalize in 2012, it is significantly higher than prior years. When that amortization starts rolling into our depreciation line, that's where you're going to see an uptick. So again, picking out the two individual line items, by far the bigger one will be the compensation and benefits line, and then the second one is down the road, it's depreciation and amortization.

Howard Chen - Credit Suisse - Analyst

Great. That's very helpful. Just moving onto credit markets here, with regards to the mix shift toward smaller trade sizes, as we maybe see dealer balance sheets improve with time, risk (inaudible) that returns to the market, do you anticipate any reversals there? How do you think that would impact your market share?



Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

I think our belief is that the new capital requirements are likely to keep dealer balance sheets lower than they have been in the past. Interestingly enough, undoubtedly risk appetite is up to start the new year with the improved market conditions in January. However, there's absolutely no sign that primary dealer balance sheets are increasing for corporate bond trading.

So, our expectation is that these changes are more permanent, and that dealers are going to operate their corporate bond trading operations with much smaller balance sheets than they have in the past. That is being reflected in the TRACE data when you see the decline in the percentage of TRACE volume being done in block trades, and the gradual reduction of the average trade size in TRACE.

Howard Chen - Credit Suisse - Analyst

Great. Thank you. Just lastly for me, I think what you mentioned earlier, kind of you're seeing an ongoing change basically in favor of e-trading. Maybe give us a sense of, in percentage terms, how much the market has moved over the last two to three years, and kind of where you ultimately see the percentage of trades that are traded electronically in the next three to five years.

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

Yes, well, we certainly see an acceleration of estimated market share gains in US high-grade over the last three years with another very strong increase in market share last year. It's our belief when we look inside the TRACE data, primarily at the type of trades that investors are most comfortable doing electronically, which tends to be in the \$5 million and under trade size category, that electronic trading over time will consume most of those \$5 million in under trades. Recently, the \$5 million in under trade size business has been representing more than half of all TRACE volume. Admittedly some of that is in the dealer-to-dealer space, but a significant portion is in the client-to-dealer space. So it's our view that the combination of the investor transaction costs improvement and the trading efficiency and the ability to reach more dealer counter-parties will continue to drive a higher market share of electronic trading in the years ahead.

Howard Chen - Credit Suisse - Analyst

Great, that's very helpful. Thank you very much.

Operator

Patrick O'Shaughnessy, Raymond James.

Patrick O'Shaughnessy - Raymond James & Assoc. - Analyst

So to circle back on expenses, Tony, can you give us the starting point or the run rate for compensation expense as we enter in 2012? So it sounds like you had, you kind of backed out some bonus accrual in the fourth quarter of '11 and you did in the third quarter of '11 as well. So where is a good starting point for 2012?

Tony DeLise - MarketAxess Holdings Inc. - CFO

Patrick, looking at the comp and benefits line, there was definitely some noise around the bonus provision over the second half of the year. I think what you've got to look at is the -- you know, it's that comp and benefits ratio for the full year 2011, which was around 32% or 33%. That's what we are looking at going forward, something in that range and then going down as our revenues accelerate. But think about that jumping-off point more consistent with the full-year comp and benefits ratio.

Patrick O'Shaughnessy - *Raymond James & Assoc. - Analyst*

Okay. That's helpful. Then something you mentioned on the prepared remarks, you have two dealers migrating off of the major dealer plan and back onto the regional dealer plan. Can you kind of give some more explanation? It's a somewhat unusual event for you guys.

Tony DeLise - *MarketAxess Holdings Inc. - CFO*

It's the first time we've had it, but I think, given what's going on on the regulatory side and capital requirements and the Volcker rule, we should expect to see some movement here and going forward. We had -- in the prepared remarks, we referenced MF Global, certainly something nobody anticipated with that particular event. Then the two dealers now that are migrating off, they will migrate onto the all-variable plan. There's pockets of liquidity that have been created post-crisis, and there's changes in business models that occur. That's going to happen. Right now, we have 27 dealers on the major plan. There will be some movement up and down. But Patrick, your observation is correct. It's the first time we've had it, so it does look a bit unusual here.

Patrick O'Shaughnessy - *Raymond James & Assoc. - Analyst*

Okay, so you guys guided for the US distribution fees to be down in the first quarter of 2012. If we assume a similar mix for US high-grade trading in terms of average trade size and average duration, because these two firms are migrating from the major dealer plan to the regional dealer plan, we should expect the fee capture for US high-grade to go up in the first quarter of 2012. Is that correct?

Tony DeLise - *MarketAxess Holdings Inc. - CFO*

I think, on the fee capture side of that, quite honestly, there's a lot of variables that go into fee capture. A lot of it has to do with duration, which is interest rate driven and years to maturity. There's the trade size that impacts it, and then there's participation by dealers on the all-regional plan, or the all-variable plan.

Looking forward from here, I think there's a good chance that -- the \$190 per million that you saw in the fourth quarter is a good chance of at least maintaining that, possibly going higher. The Fed recently signaled they are going to keep interest rates at near 0 through 2014, look at trading on our platform, years to maturity of the last several quarters, and again here in January have been in that 8.5- to 9-year range.

The yield curve has flattened a little bit here but it's been more of the short and midterm range. So we are still anticipating this longer duration or years to maturity.

Even on the trade size, there's some -- we had some discussions here on the trade size coming down. That did impact us as well, and it favorably impacted us with our fee plan. There's a couple of breakpoints that are, you know, the smaller the trade size, the higher the fees. So we look at these factors.

Patrick the one you pointed out with a couple of dealers migrating down, we think, near-term, that \$190 per million we think is a pretty good number near-term. It possibly could go higher if the all-variable dealers increase their participation.

Patrick O'Shaughnessy - *Raymond James & Assoc. - Analyst*

Okay. That's helpful, thanks. Then to kind of close the loop on the dealer environment, given that it seems like across asset classes, trading volumes have been a little bit soft. You guys had a really nice run over the last few years of signing up new dealers, both major and regional. Do you kind of think that growth in your dealer base is more or less going to taper out at this point?



Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

I think it's unlikely that we will take on new dealers at the same pace that we have over the last three years. There are firms increasing their commitment to credit trading virtually every quarter, and we will see some of those coming in, and we will also see some dropping out as we did with MF Global during the fourth quarter. But I think, in terms of the total number of dealers active in the US, you should not expect to see a significant increase over the next year or two. We think there is more to be gained from their participation and increased volume on the system across a number of different products. I think you will see that continue over the next year or two.

The other part is that we do believe we can do a better job with new dealer acquisition and being more flexible on fee plans in Europe. So, we would like to follow the success of that dealer expansion in the US in the European region. That's one place where we hope to be able to show a larger dealer community over the next several years.

Patrick O'Shaughnessy - Raymond James & Assoc. - Analyst

Okay. That segues very well into my last question before I jump back in the Q, which is, in Europe, you talked about having a 50% cost reduction for your monthly distribution fees. So is the goal behind that basically to prevent dealers from leaving because volumes are so slow? Is it to get more dealers to sign up? Is it to try to stimulate an increase in market share? I'm guessing you're going to say it's all of the above, but if you can talk through that, that would be helpful.

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

Yes, I think we do look at our fee structures in all products at all times to try to determine what's best for our dealer and investor clients and what's best for our shareholders. It's clear that, with the reduction in volume that we saw throughout 2011, the distribution fees were higher than they should have been. We were proactive about this because these are many of the same dealers that are very important to us in the rest of our product areas, in the US high-grade emerging markets, high-yield, and important our development plans in CDS. So we wanted to address the distribution fee proactively in Europe.

The key for us in that region and for our entire business is to grow volume in variable revenue. That's where our growth has come from in the largest way in the past, and that's where we expect it to come from in the future. So with these changes, we think we are in the right place with dealers in Europe and we think we have a better value proposition for new dealers that we are trying to attract.

Patrick O'Shaughnessy - Raymond James & Assoc. - Analyst

Okay, very helpful. Thank you.

Operator

Hugh Miller, Sidoti & Co.

Hugh Miller - Sidoti & co. - Analyst

Good morning. I figured maybe I'd start off with a couple of housekeeping questions, one of which you mentioned the expected share count following the buyback, but I didn't catch when you expect that to be completed by.



Tony DeLise - *MarketAxess Holdings Inc. - CFO*

It's Tony. On the buyback, we do expect the buyback to be completed over the next several months. We have been active in the market since mid-December. We've got a program set up so it's running pretty much on autopilot. With that, if it's completed over the next several months, for arguments sake, let's say it's completed by the end of the first quarter, that full impact that I referenced you would see in the second quarter.

Hugh Miller - *Sidoti & co. - Analyst*

Right. Yes, certainly. Then just a couple other housekeepings, one of which was the reduction then from the fall-off of the two dealers on the US high-grade major platform, expected \$1.2 million lower fixed rate fees?

Tony DeLise - *MarketAxess Holdings Inc. - CFO*

So Hugh, on the -- what I had talked about in the prepared remarks was distribution fees compared to the fourth quarter. There's -- the impact in there, it's really twofold. It's one month of the European distribution fee reduction, and then it's the impact of these two US dealers migrating down.

Hugh Miller - *Sidoti & co. - Analyst*

Okay. So, if you net out the \$450,000 -- okay. So in other words, you just have to figure out the one-month from Euro, and then the remainder would be the change from the US high-grade.

Tony DeLise - *MarketAxess Holdings Inc. - CFO*

That's right. Not that I'm trying to be cute with giving forward-looking information, but just if you take it one more quarter to the second quarter, we have the full impact of Europe, we have the full impact of the US dealer migrations. We would expect the distribution fees, again, if there's no other changes in our dealer community, we would expect a further \$1 million reduction in distribution fees in the second quarter. So again, compared to the fourth quarter, what I mentioned in the prepared remarks, \$1.2 million reduction in Q1, and then a further \$1 million reduction in Q2. Again, if nothing else changes with our dealer composition, we would expect that to continue for Q2, Q3, Q4.

Hugh Miller - *Sidoti & co. - Analyst*

Okay. On the European, it's a 50% reduction effective March 1.

Tony DeLise - *MarketAxess Holdings Inc. - CFO*

Correct.

Hugh Miller - *Sidoti & co. - Analyst*

Okay, all right. You guys also mentioned in the prepared remarks about that you are seeing the meaningful benefit for investor execution for electronic relative to telephone-based. I was wondering if you could talk to us a bit about any quantifiable numbers that you are seeing on how much of an advantage electronic is relative to telephone-based trading?

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

We are doing more and more work on transaction cost analysis in US high-grade in particular where we have the benefit of the TRACE tape. You could see bid offer spreads widening out during the fourth quarter as the market conditions became more difficult. Our average cost savings within the corporate bond trades that we conducted during the quarter were around 4 basis points per trade.

Hugh Miller - Sidoti & co. - Analyst

Okay. I guess piggybacking off of the change in market conditions from the fourth quarter into what we're seeing right now in early 2012, as you think about TRACE volumes and considering that they were relatively flat in 2011, what do you see as the dynamics there as you think about the business with just industry volumes aside from your ability to take market share?

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

Obviously, a lot of factors will go into the TRACE volume for 2012, many of which we can't possibly predict today. Having said that, this continues to be an environment where investors need yield. Government bond yields, especially in the US, are extremely low, and we are seeing inflows in investors moving into credit and we are seeing them invest at the longer end of the curve where they can find more yield.

I think the one mitigating factor to TRACE volumes during the second half of the year were the significant concerns coming out of Europe. At least temporarily, there is a much more meaningful funding solution coming out of the ECB that's led to a significant rally in credit spreads in the European region that's having a ripple effect into the US. So, the combination of the search for yield and the increased confidence in credit and the European solution is driving significant growth in trading volumes versus where we were in the second half of last year.

So right now obviously this is a very favorable environment, and we would expect that the increase that we've seen in corporate bond debt over the last three years does give rise to more turnover in a normal credit-trading environment, so we remain hopeful and optimistic that TRACE volumes will be active throughout the year.

Hugh Miller - Sidoti & co. - Analyst

Okay, appreciate the insight there. I guess, if you take a look at the slides, you do see obviously the hit rate in the fourth quarter was a bit lower than the third quarter. I know there was a particular softness in October, but was wondering if you could provide us some color there on kind of how the hit rate was at the end of the year in December, and any trends there that we are seeing into early '12.

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

I don't know that we've got the monthly numbers on the hit rate in front of us this morning, but it definitely was related to the environment. We have seen an uptick, as I mentioned earlier, in hit rates during the month of January, but we are not yet back to what we would consider a very healthy hit rate environment, which is where you see the MarketAxess hit rate tend to be somewhere around 75%. We are not back up to that level just yet.

Hugh Miller - Sidoti & co. - Analyst

Okay. The last question I had was, when you think about incremental operating margin now at about 80% from closer to 65% historically, even with some of the investments you've made kind of in preparation for CDS, when I think about it, I would suspect that's just the shift in dealer participation mix, and then also obviously you guys have made some adjustments on the comp accruals. But are there any other factors? If not, what's really driving that? Is there one driving it more than the other?



Tony DeLise - *MarketAxess Holdings Inc. - CFO*

On the incremental margins and maybe be more specifically on what the expectations are going forward, it was 80% in 2011. There were some items driving that. I think we are more comfortable talking about what's happened over the last five or six years, and that's been more in the 65% to 70% range.

As I mentioned before, even when you look at our expenses going forward, the expense increase mainly comes from the compensation and benefits line, and that is controllable in large part. So I think we continue to target these incremental margins in that 65% to 70% range. If we can grow that topline revenue number, it's going to drive our overall margins higher.

Hugh Miller - *Sidoti & co. - Analyst*

Okay, appreciate that, thank you.

Operator

Niamh Alexander, KBW.

Niamh Alexander - *Keefe Bruyette & Woods - Analyst*

Good morning. Thanks for a solid quarter.

I just wanted to touch on, firstly, the dividend, and because you had indicated that you would deploy your excess cash for buybacks and dividends and you hiked the dividend. But I guess I thought your longer-term kind of target yield was closer to 2%. So am I correct in thinking about you're holding a little bit back here? Are you starting to see some acquisition opportunities? Help me understand that.

Rick McVey - *MarketAxess Holdings Inc. - Chairman, CEO*

On the dividend, maybe I'll let Rick talk about the acquisition side of things. But on the dividend itself, we did have some initial targets there that we had expressed, which was that 2% to 2.25% yield and paying out around a third of our free cash flow. Share price, quite frankly, has taken care of that first item. Prior to making this -- to adopting the increase here in the dividend, we are down around 1.2%. We got up to about 1.5% yield.

I think more important than that, the Board, when we are looking at dividends, this is our second consecutive annual increase. I think the more important thing to look at is what we are paying out in terms of either free cash flow or EPS now is around 30%, so it's pretty close to that target that we set up.

Even looking at the combination now of the buyback and the dividends, we're going to pay out around 85% of free cash flow generation in the combination of those two items. It's -- so I'd say that those initial targets are not hard and fast targets, but probably the more compelling item was around our payout ratio and, again, sort of targeting that one-third payout ratio.

Niamh Alexander - *Keefe Bruyette & Woods - Analyst*

Okay, that make sense. Thank you. I guess, on the acquisitions, I felt over the last few months maybe you've been signaling that maybe you are starting to see some opportunities. I thought maybe retail came up. Can you give us an update on that?

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

Not really nothing new to report. I think that the key message is that we continue to be very enthusiastic about the organic growth opportunities and confident in our capabilities to execute on those opportunities. So the Company's primary focus is on organic growth. No change. We do look at things and if we can find complementary acquisitions, we would be interested, but our primary focus is on organic growth.

But as it relates to the dividend and our balance sheet, we do like a strong balance sheet for a whole host of reasons. One of them is based on our ability to be opportunistic if the right acquisition does come along.

Niamh Alexander - Keefe Bruyette & Woods - Analyst

Fair enough. Thanks. Can I get an update on what are you doing now with respect to (inaudible) CDS? Because you are actually clearing some of the credit default swaps and I think, realistically, we probably shouldn't be modeling any revenue or net contribution to earnings, shall we say, from this kind of nascent product for another year or so. Is that fair, but can you give us an update on what's actually happening?

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

Yes, happy to. Actually, the fourth quarter, in terms of product development, was a very productive quarter for us. We have about nine dealers streaming executable CDS index levels through MarketAxess now. We have been able to develop some new trading protocols around not just RQ but streaming quotes and request for markets. We are getting clients to start trying the new functionality that we have available on the CDS system, and we are working very hard on post-trade connectivity and we have established most of the links that we need to the clearinghouses and the affirmation hub. So a lot of work has gone into it and a lot of work has gone into preparing to register and apply to be a SEF.

With respect to trading volumes, it's still a small part of what we are doing. There's more activity over the last quarter, more clients and dealers participating, but it's still a very small part of what we are doing. I think there continues to be a lot of uncertainty about the regulatory outcome and what the final rules will look like. I think that the CDS market is looking for more clarity before really starting to change their trading behavior in a larger way.

Niamh Alexander - Keefe Bruyette & Woods - Analyst

That's helpful. Thanks. Just given the regulatory kind of hold-up as it were, everyone is and clearly you are going ahead and making investments and getting the connectivity to the clients. But is it more realistic just to expect this to potentially get more incrementally additive to the earnings, so 2013 at the earliest?

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

It's been a moving target and it's hard to say. I think it's exactly what I said in my prepared comments, that the CFTC has bucketed the SEF rules in the April and beyond category. We hear anecdotally that they have SEF rules in mind for the early part of that window, which would hopefully be this spring, but the market will need time before fully implementing those rules. They have consistently talked about 180 days from rules being finalized, implementation dates. So I think, with respect to the big catalyst and the regulatory changes, yes, it would appear to us now that the best guess is those rules will be implemented sometime around the end of this year.

Niamh Alexander - Keefe Bruyette & Woods - Analyst

Fair enough. Thanks Rick. I appreciate the answer there.



Just on the other one, the \$1 million question, the market share gains, it's a very -- consistent performance last year in terms of the market share growth on top of the prior year as well. Where are the opportunities? Where are the biggest opportunities to continue growing the market share at that pace? Are there maybe some potential big customers that you could bring on board? Is it deeper penetration of existing customers, or is it also the market structure shift in that just more of the dealers kind of doing the smaller trades away from phone?

Rick McVey - *MarketAxess Holdings Inc. - Chairman, CEO*

Yes, I think it's all of the above, really. We are working very hard, as always, on promoting the benefits of electronic trading on MarketAxess to investors and dealers.

On the investors side, I think the transaction cost analysis and the price improvement is making a big difference in the way they think about order flow coming into the MarketAxess system. We do still have some very large clients that do very little electronic trading. They are all on MarketAxess, but they are doing far less than their peers on average, so we are redoubling our efforts with them to get them to embrace the system more significantly.

We also are using the TCA work to prove that price benefit applies not only to small trades but to larger trades as well to get investors more comfortable with moving their trade sizes up. Some of them sit in very small trade sizes electronically and are not even pushing the \$5 million and under boundaries yet. So we think there's more we can do on moving the trade size up.

I think you should expect us to continue to be ambitious about expanding trading conductivity on the platform. These changes will continue to create new trading desks and new dealers, and there's a lot of interest in using electronic trading to connect with more and more counter-parties. You should expect that to be part of our strategy going forward.

Niamh Alexander - *Keefe Bruyette & Woods - Analyst*

Fair enough, I'll get back in line. Thanks so much.

Operator

Michael Wong, Morningstar.

Michael Wong - *Morningstar - Analyst*

Good morning. Can you remind me if your planned OTC derivatives SEF platform will be more vertically focused buy side to sell side versus let's say sell side to sell side, and if your current buy side customer base are already large users of credit default swaps?

Rick McVey - *MarketAxess Holdings Inc. - Chairman, CEO*

Two good questions. We -- our primary focus continues to be the institutional customer to multi-dealer space. That is our focus in CDS, just like it is in bonds. I think it's quite possible that, over time, on the back of central clearing and more electronic trading, when you look at the most liquid swap contracts like the CDS indices, that there may be some blurring of those lines between the client-to-dealer and dealer-to-dealer space. But our primary focus is client-to-dealer, and we think that market segmentation for the most part will remain in CDS much the way that it is today.

Michael Wong - Morningstar - Analyst

Okay. In terms of your traditional US high-grade customer base behavior, besides extending the duration of the bonds they trade of US high-grade, have they also been contributing more towards your other products such as emerging market debt?

Tony DeLise - MarketAxess Holdings Inc. - CFO

It's Tony. Yes they have. I don't have the statistics in front of me on the number of products traded by clients. I apologize for that. But yes, that is the case. Even when we look across each one of our products, we have more clients trading across each individual product quarter-over-quarter. Again, I guess I don't have those particular statistics in front of me, but that increase in client participation across each individual product is coming from our existing client base.

Michael Wong - Morningstar - Analyst

Thanks for taking my questions.

Operator

Patrick O'Shaughnessy.

Patrick O'Shaughnessy - Raymond James & Assoc. - Analyst

A couple more follow-ups for you. The first is on your Other product group. Pricing was down a little bit sequentially in the fourth quarter. I apologize if you already spoke about that, but I assume that was just a function of product mix where you did more agencies and less relative in high-yield and emerging markets. Assuming that's the case, kind of was curious what your expectations are for 2012.

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

Sure Patrick. You're right. That decline in fee capture really mix-driven, and does not revolve around agencies and a little bit of CDS.

I'll tell you one thing. Prospectively, I think we're going to give you a little more information, particularly on CDS or at least breaking out credit derivatives from the credit bonds that are traded, so that we take out some of that noise around fee capture. So when we plan on releasing volumes in all likelihood tomorrow, at that point in time, we'll try and give a little more clarity on what's going on around CDS. But in terms of that decline, Q3 to Q4, mix-driven, the fee capture across the individual products, whether it was agencies, emerging markets, high-yield, individually did not change, but some change in the mix there.

Patrick O'Shaughnessy - Raymond James & Assoc. - Analyst

Then 2012, I think it sounds like you are trying to place some emphasis on growing your emerging markets on high-yield business. Do you think you're going to get much traction to the extent that we should see your fee capture maybe pick up a little bit?

Rick McVey - MarketAxess Holdings Inc. - Chairman, CEO

We were really pleased with the growth across all three of those categories in 2011. The trend seems to be in place that investors and dealers are doing more electronic trading across all credit products, so we would remain optimistic that there are growth opportunities in 2012 for all of those product areas.



Having said that, the absolute level of volume is highest currently in agencies. As you know, that is where we have a lower fee capture due to lower bid offer spreads in the agency market. So, I think that's something to watch that growth rates could be the same but we would still be accumulating more volume in that category in the agency product. But certainly in the kind of environment that we've had in January, we are very optimistic about the electronic trading appetite for high-yield and EM as well.

Patrick O'Shaughnessy - *Raymond James & Assoc. - Analyst*

Okay, fair enough. Then lastly, I want to touch on your dealer-to-dealer initiatives. I know you touched on it a little bit in past calls. Just kind of wanted to get an update on where you stand as far as dealer-to-dealer. How big of a priority is that for you? With trade sizes maybe ticking down a little bit, does that make it maybe more -- provide a little bit easier entree into the dealer-to-dealer space?

Rick McVey - *MarketAxess Holdings Inc. - Chairman, CEO*

It does. I don't think you should think of us in the dealer-to-dealer space as a primary competitor of the large inter-dealer brokers. We are trying to help our dealer clients address the balance sheet issues that they are currently facing. There is a lot of demand to move \$3 million in underline items off balance sheets more quickly than they have in the past. It really wasn't a priority three years ago for dealers to move those bonds off their balance sheet. If they could sell them, great. If not, they were happy to manage that risk and earn carry on those line items. The environment is very different now and they don't want to clutter their balance sheet with lots of small ticket line items in corporate bonds. With about 55 or 60 dealers participating in high-grade and even more in our D-to-D initiative, allowing dealers to send lists and inquiries to each other so that those bonds can more quickly find a natural home and reduce overall balance sheets, is a service that we think fits these times very well with our dealers. We are seeing increased take-up, and we are, at their request, making some technology changes to be able to do more of that more efficiently. So, we do think it's a new opportunity. It's a small piece of what we are doing today, but we think it's another sign that electronic connectivity can help dealers with the balance sheet constraints that they are currently confronting.

Patrick O'Shaughnessy - *Raymond James & Assoc. - Analyst*

Thanks, very helpful.

Operator

There are no further questions at this time. I will now turn the call back to Rick McVey for closing remarks.

Rick McVey - *MarketAxess Holdings Inc. - Chairman, CEO*

Thanks very much for joining us this morning, and we look forward to talking to you next quarter.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.



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