

# FINAL TRANSCRIPT

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**MKTX - Q2 2011 Marketaxess Holdings Inc Earnings Conference Call**

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## CORPORATE PARTICIPANTS

**Dave Cresci**

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**Rick McVey**

*MarketAxess Holdings Inc. - CEO & Chairman*

**Tony DeLise**

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## CONFERENCE CALL PARTICIPANTS

**Daniel Harris**

*Goldman Sachs - Analyst*

**Niamh Alexander**

*Keefe, Bruyette & Woods - Analyst*

**Hugh Miller**

*Sidoti & Co. - Analyst*

**Patrick O'Shaughnessy**

*Raymond James & Associates - Analyst*

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*Credit Suisse - Analyst*

## PRESENTATION

**Operator**

Ladies and gentlemen, thank you for standing by. (Operator Instructions). Later we will conduct a question and answer session. (Operator Instructions). As a reminder, this conference is being recorded, Wednesday, July 27, 2011. I would now like to turn the call over to Dave Cresci, Investor Relations Manager at MarketAxess. Please go ahead, sir.

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

Good morning and welcome to the MarketAxess second 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.

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

Good morning and thank you for joining us to discuss our second quarter 2011 results. We are pleased to report another set of strong quarterly results with revenues of \$45.8 million, up 30% from a year ago and pre-tax income of \$19.9 million, 68% above the second quarter of 2010. The second quarter marks the ninth consecutive quarter of record revenues and earnings. Diluted EPS improved to \$0.30 compared to \$0.18 one year ago. Total trading volume was \$133 billion, up 35% from a year ago. Our estimated US high grade market share increased by a full 300 basis points, to 11.1%. Trading volume in our other product category was up 54%. Fee capture per million traded remained strong due to the high quality mix of bonds traded and another strong quarter for execution fees from our regional dealer fee plan.

Slide four displays some details on our financial strength. The expansion in the MarketAxess trading network is helping to drive robust increases in quarterly revenues. Year-over-year distribution fees increased by 27% and regional dealer variable execution fees increased by 55%. This strong revenue growth and our on-going focus on expense management led to record operating income of \$19.9 million. EBITDA reached a record \$21.5 million and operating margin reached a record 43%. Our cash and securities balance at June month-end was \$212 million, or \$5.35 per diluted share. The board of directors approved a quarterly cash dividend of \$0.09 per share.

Slide five provides an update on market conditions. Second quarter market conditions remain favorable for fixed income e-trading activity. The yield curve remains steep with a spread between 10 year and the 3-month Treasury yields at approximately 300 basis points. Taxable bond funds and corporate bond ETF inflows remain positive for the second quarter at approximately \$14 billion. US high grade TRACE volumes were \$730 billion in the second quarter in line with the average quarterly pace of the last few years. US corporate debt outstanding was over \$7 trillion at year-end, 2010, and has increased 26% since 2007. The increase in TRACE volume since that time is running on a parallel track with the increase in corporate debt outstanding.

Slide six highlights our improved client and dealer participation. The cumulative number of client and dealer trading connections has more than doubled since we began the dealer expansion in 2008. Clients are receiving twice as many dealer responses for high grade inquiry compared to two years ago. Enhanced dealer liquidity and competition are driving meaningful transaction cross-savings for investors across all trade sizes. Lower transaction costs are driving increased investor order flow. Unlike previous pre-crisis peaks, current market share levels are driven primarily by trading in fixed rate bonds, which generates a much higher fee capture than floating rate notes.

New dealers accounted for approximately 26% of the trading by count and 18% of trading by volume during the second quarter. Variable conditions generated from new dealers on the all-variable, regional dealer fee plan reached \$4 million during the second quarter and greatly contributed to the sequential increase in US high grade fee capture. Our July month-to-date estimated US high grade market share is in line with second quarter levels.

Slide seven summarizes the trading volume across our product categories. Overall global volume was up 35% year-over-year to \$133 billion. US high grade volume was \$81 billion, up 39% year-over-year driven solely a gain in market share as TRACE volumes were roughly flat with year-ago levels and down 15% from the robust first quarter levels. Eurobond volumes were down 22% from the second quarter of last year as sovereign debt concerns continued to impact the market environment. The other product category volumes increased to \$42 billion, up 54% from a year ago. Of note, we achieved record quarterly volumes in all three major product categories including High Yield, Emerging Markets, and Agency Bonds.

We are also continuing to invest in significant new functionality for CDS trading in light of the anticipated SEF rules. Our system now offers streaming, executable CDS prices in addition to our existing Request for Quote protocol. We have also enhanced our post-trade functionality for trade affirmation as well as connectivity to the clearing houses.

Finally, I want to thank Kelley Millet for his contribution to the Company's success in his five years as President of the firm. Kelley left MarketAxess earlier this month to take up the role of CEO of Cortview Capital, a regional broker-dealer and MarketAxess



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customer. We wish him all the best in his new role. Now, let me turn the call over to Tony for more detail regarding our second quarter financial results.

**Tony DeLise** - *MarketAxess Holdings Inc. - CFO*

Thank you, Rick. Please turn to slide eight for our earnings performance. Revenues of \$45.8 million were up 30% from a year ago, driven principally by trading commission growth. The \$4 million in second quarter technology products and services revenues represent a historical high and we are cautiously optimistic about the near-term sustainability.

Total expenses were \$25.9 million, up 10% from the second quarter of 2010 and flat sequentially from the first quarter. Almost one-half of the year-over-year increase is attributable to new product areas, in particular, SEF-related spending. Second quarter expenses include a \$1.1 million favorable adjustment to reflect the cancellation of certain unvested equity grants upon Kelley's resignation.

Pre-tax income was a record \$19.9 million in the second quarter, up almost 68% from last year. Our incremental margins for the first half of 2011 were 76%. This means for each additional revenue dollar generated, approximately \$0.76 fell to the operating line demonstrating the significant leverage in our business model even as we continue to invest in new product development.

Our effective tax rate for the second quarter was 40%, up slightly from the first quarter. We expect our full-year tax rate to be in line with our 2011 guidance of 38% to 41%. Our diluted earnings per share of \$0.30 was the highest we have generated as a public company.

On slide nine, we have laid out our commission revenue, trading volumes and fees per million. Record distribution fees of \$15.6 million were up \$3.3 million from the second quarter of 2010 due mainly to the migration of several dealers from the regional plan to the major plan in the second half of 2010 and early 2011. We expect two additional dealers to move to the major plan in the second half of this year. Compared to the second quarter level, quarterly distribution fees are projected to be modestly higher in the third quarter and upwards of \$1 million higher in the fourth quarter once the full impact of the dealer movement materializes.

US High Grade fees per million increased from \$172 in the first quarter of 2011 to \$184 in the second quarter. The increase was primarily due to the substantial jump in execution fees generated by our regional plan dealers. In total, we would expect the dealer migration to be roughly revenue-neutral with a decline in variable transaction fees offset by an increase in distribution fees.

The other product category fee capture increased to \$182 per million for the second quarter of 2011, compared to \$166 for the second quarter of 2010 and \$176 for the first quarter of 2011. The relative volume contribution from High Yield, Emerging Markets and Agency Bonds was very consistent across each of these periods. The growth in average fees per million in the other product categories reflect a higher quality mix of High Yield and Emerging Market bonds traded.

Slide ten provides you with the expense detail. Total expenses for the second quarter were up 10% from a year ago. The majority of the year-over-year increase was due to a higher incentive bonus accrual resulting from improved operating performance and a ramp-up of SEF-related expenses.

Expenses for the second quarter were flat sequentially to the first quarter of 2011. The decline in employee compensation and benefits' expense was due to the \$1.1 million equity grant cancellation adjustment. Excluding this adjustment, the normalized second quarter expenses would have been closer to \$27 million. Consistent with the view we supplied in our last earnings call, we expect that full-year, 2011 expenses will be towards the upper end of the original \$101 million to \$107 million guidance range.



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We now expect full-year 2011 capital spending to be in the range of \$5.5 million to \$7 million. The increase from our initial guidance of \$4 million to \$6 million reflects higher capitalized software development expenditures related to new products.

On slide 11, we provide balance sheet information. Cash, cash equivalents and securities as of June 30 were \$212 million compared to \$198 million at year-end 2010. Our 12-month trailing free cash flow of \$55 million was more than sufficient to cover our recurring quarterly cash dividend and other capital needs during the period. The current dividend rate represents a payout of approximately 25% of the trailing 12-month, free cash flow.

As we communicated on our last call, we believe that available unrestricted federal tax laws and credit carry-forward have now been exhausted. We entered a new era as a federal tax payer in the second quarter. There was no change in our capital structure during the second quarter and we continued to have no bank debt.

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

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

Thank you, Tony. We are pleased with both the pace and the breadth of growth reflected in the results we reported this morning. The economic benefits of electronic trading in fixed income are becoming more obvious to investors, dealers and regulators. We are fast at work to continue to capitalize on the many opportunities still in front of us for electronic trading in bonds and CDFs. With that, I would be happy to open the call for your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions). Daniel Harris, Goldman Sachs.

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**Daniel Harris** - Goldman Sachs - Analyst

Good morning, guys. Rick, you mentioned that the market share in high grade just continues to move higher and even sequentially here it was up very nicely. As you look forward, I know historically you had talked, I think a couple of years ago, about getting close to a quarter of the industry. I mean, as you look forward, what do you see that opportunity as? Is it still something that high? Could it go higher? And does that path march on to the tune of 100, 200 basis points a quarter?

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

Thanks, Dan. You know, the TRACE numbers still support roughly 50% or slightly above of the overall corporate bond secondary market taking place in \$5 million and under trades. It's our view that the economic benefits in electronic trading will continue to drive most of that business to electronic trading. We today, as you know, are achieving almost all of our market share gains in the client, the dealer business, and there is a portion of that that's inter-dealer, but our view is that 35%-40% market share overall is an attainable figure longer-term in terms of the market share that we would expect to go electronic.

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**Daniel Harris** - Goldman Sachs - Analyst

Okay. Good to hear your thoughts there. As you guys continue through the relationship building process, moving from cash bonds into the other fixed income products specifically that would be moving onto a SEF over the next few years, can you talk a little bit about the relationship building process that you're going through right now with not only the, maybe the trading



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desk, but also the technologists that are implementing those platforms at the dealers and how those discussions are going with regards to what they're considering for implementation, not just from a timeline perspective, but more what are they looking for and how are you servicing those needs in terms of near-term versus obviously, the longer term Dodd Frank implications?

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

Yes, that's a very good question and there's a lot of work going on behind the scenes with dealer connectivity for market making in CDFs onto the MarketAxess platform, so there's a lot of work going on with APIs and the technology teams of the leading dealers for OTC derivatives today. I think that they're looking for platforms that are going to offer attractive distribution for OTC derivative trading, technology that they know is robust and scalable with APIs that will be efficient to integrate to and companies that they are comfortable working with. I think we check all of those boxes, so this quarter as I mentioned in some of my prepared remarks, we have introduced a new trading protocol. We've moved into multi-dealer streaming quotes where at least for the most liquid CDF swaps, an increasing number of dealers are able to push executable prices to us on the MarketAxess system. We would expect to see six or seven new dealers coming on-board with streaming quotes during this quarter, initially for index trading, but we also believe that actively traded single names will follow in the not-to-distant future.

**Daniel Harris** - *Goldman Sachs - Analyst*

Okay. Thanks a lot and just one last question. You're obviously exceptionally well-versed in what's going on down in DC and certainly with regards to timing and the thoughts of final rule-making. I'd love to get your updated views on how you think that progresses, not only just from timing of the final rules, but also what do you think is going on with regards to implementation time frames following the actual rule set? Thank you.

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

It's difficult to be well-versed. There are a lot of hands in the pot and a lot of moving parts, as you know, Dan, but I think we continue to hear from both Commissions that they expect to finalize the rules over the next four or five months and there will be a sequence of public hearings when they're releasing those rules. We would think that the SEF rules will probably be in the second half, so we would expect the kind of late fall we would see the rules start to emerge for SEFs. They have consistently talked about implementation dates that would follow about six months after the rules are finalized, so that puts us late second quarter, middle of next year. The only wild card, as I'm sure you're aware, Dan, is that there is discussion that some of the final rules, or rule proposals, might differ enough from the initial rules that they would need to be re-proposed, which would open up another comment period and probably push the timeline for implementation back three to six months. We do not know whether the SEF rules would qualify in that category and need to be re-proposed, but that is certainly one of the risks, but we are preparing our business so that we will be fully ready for the SEF requirements by the end of this year and I think we're ready for just about any outcome with respect to the way the final rules go.

**Daniel Harris** - *Goldman Sachs - Analyst*

Excellent, Rick. Thank you very much.

**Operator**

Niamh Alexander, KBW.

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**Niamh Alexander** - Keefe, Bruyette & Woods - Analyst

Hi, thanks for taking my questions and congrats on a really, really strong quarter. Nice revenue growth in this environment. Could I talk to the operating margin potential, Rick and Tony, because you delivered 43%. You mentioned 76% in terms of incremental margins, so how should we think about if, for example, growth continued at this pace, what's the kind of run rate maximum operating margin potential there?

**Tony DeLise** - MarketAxess Holdings Inc. - CFO

Niamh, it's Tony. Thank you for the question. I mentioned the incremental margins were around 76% for the first half of the year and just if we selectively look at a couple of one-time items. We did have the adjustment for Kelley's grant cancellations and also, you recall in the first quarter, there was a sales tax reimbursement claim, a favorable claim there. But even when you exclude those, it's right around 70% incremental margin and that's very consistent with our 5-year pattern, which is right in that 65% to 70% range. When we look at going forward using history as a bit of a proxy here, we continue to believe that that 60% to 70% incremental margin range is what we're targeting going forward and that's including the investments that we're making in new products. So we think just projecting that out, you can get to a 50% plus margin if we were roughly to increase revenues by another \$100 million from our second quarter run rate. So that, even the thinking about that that would get us up to say \$275 million or \$300 million in revenues and margins about 50% at that time.

**Niamh Alexander** - Keefe, Bruyette & Woods - Analyst

Okay. That's really helpful. Thanks, Tony. I appreciate the color. If the business is that attractive and that profitable, it often kind of begets some competitors having another go, a kind of having some success there. Have there been any other movements from the kind of the three that are in your space, in the US especially, or anything new over the last quarter?

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

On the competitive front, Niamh?

**Niamh Alexander** - Keefe, Bruyette & Woods - Analyst

Yes.

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

I don't think there's anything new. I think the competitive space today is very much as it was a year ago. Obviously we're very pleased with the momentum that we're seeing, not only in high grade market share, but also the tremendous volume growth that we're enjoying in Emerging Markets, High Yield and Agency Debt. So, I think our position remains very strong in US electronic trading of credit and we don't see any significant changes on the competitive front.

**Niamh Alexander** - Keefe, Bruyette & Woods - Analyst

Okay, that's helpful. Thanks, Rick. If I could touch on Kelley's departure, obviously going off to be a CEO somewhere else and we wish him well. Are you going to replace Kelley internally or who's going to kind of take over that management responsibility or managing those relationships that Kelley had done, too?

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

You know, we're very pleased to have a very deep management team and a lot of depth around the organization in general. Kelley has said in many venues that he wasn't looking for a job. This one came to him, so his departure came up more quickly than anyone expected, including Kelley. He was attracted to the opportunity and rightly so. He'd done a lot of work here as the President of a public company and was well-positioned to take on a CEO role. It obviously fit with him personally in terms of getting back into capital markets with the opportunities that are emerging in the regional dealer community. So, it's a great opportunity for Kelley.

In the short-term, Niamh, we are reshuffling some responsibilities internally. We are very confident with the team that we have that we can continue to grow in earnings momentum that we have been enjoying and we think we've got time to reflect on the team that we have and carefully consider both internal and external choices over the intermediate term.

**Niamh Alexander** - Keefe, Bruyette & Woods - Analyst

Okay, that's helpful. I appreciate that, Rick. Then, just lastly, the market share which, the growth has been impressive. I think, over in meetings with investors and publically, you've kind of targeted around 3% growth in the year or anything like that, and you're already doing so well there, do you think you see kind of maybe in terms of new clients on boarding and just increased inquiries that a more, we should be upping the expectations for share gains?

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

Obviously a very important question. We've had an excellent ratio of share gains over the last four to six quarters, but I really think that the structural changes that taking place in the market are very favorable for on-going share gains for electronic trading. The capital requirements are going up for large banks and dealers, which means that their balance sheet capacity for market making is going down. That is creating new opportunities for regional dealers and alternative dealers. Investors, in order to source the liquidity that they need in credit markets, are accessing a much broader group of dealers today than they did three years ago and the only way to do that efficiently is to do it electronically.

So, we are seeing enhanced dealer competition on the trading system. We're seeing dealers more focused on reducing costs than they have been in a long time. The enhanced competition on the MarketAxess system is driving transaction cost savings to investors and as a result, they're putting more order flow back into the system. We are seeing good progress on some of the late adopters that we've talked with all of you about in the past. We're seeing good increases in share and volume across the different trade sizes. So, our view is that the macro-trends continue to be very favorable for greater electronic trading in the credit markets.

**Niamh Alexander** - Keefe, Bruyette & Woods - Analyst

Okay, thank you, Rick.

**Operator**

Hugh Miller, Sidoti.



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**Hugh Miller** - Sidoti & Co. - Analyst

Morning. One question I had was with regards to taking a look at the sequential rise in the variable fee capture for US high grade. Can you talk about the split, the impact between the yield curve versus the dealer mix and if there was any other benefit? Just give me a sense of what's kind of driving that incremental increase.

**Tony DeLise** - MarketAxess Holdings Inc. - CFO

Sure, Hugh. Hugh, in the second quarter, so comparing the first quarter US high-grade fee capture of 172, to the second quarter of 184, that increase is almost solely related to the increase in the execution fee from the regional dealer plan. We look at -- the other factor would be shape of the yield curve or years to maturity trading over the platform. It changed a little bit quarter-over-quarter, but really not enough to swing that fee capture number, so it is almost solely related to the regional dealer plan. As Rick mentioned, those fees were up 55% year-over-year, absolute number was about \$4 million and just, you can do the quick math on it. The regional dealer execution fee at \$4 million equates to something around \$50 per million and if you look back and do the math for the second quarter of last year, it was closer -- or even for the first quarter was closer to \$37 or \$38 per million, so the entire increase was due to that additional execution fee.

**Hugh Miller** - Sidoti & Co. - Analyst

Okay, great color there. Obviously you guys have talked about a revenue-neutral scenario when you've been migrating a dealer from regional to the fixed-rate plan, but as you look back on the handful of dealers that have stepped up over the last year, can you talk about the volume trends you've been seeing following that and whether or not you are seeing that increased commitment to drive liquidity on the platform?

**Tony DeLise** - MarketAxess Holdings Inc. - CFO

Hugh, on that one, we did drop a chart which we've had in there historically, but Rick mentioned in his comments that the new dealers on the platform, they represent 26% of ticketed-by-count and 18% by volume. That 18% number is a high-water mark, so the new dealers continue to drive additional volumes over the platform. With the new dealers and even the dealers specifically on the regional plan, we've had four migrate up. Two additional ones are migrating up in the second half of the year and behind those dealers that have migrated up, there are up-and-coming regional dealers that are continuing to drive volume.

**Hugh Miller** - Sidoti & Co. - Analyst

I guess my question was more specifically to looking at the dealers who have already migrated up. At the time when you are making that change is kind of revenue-neutral with a reduction in fee capture versus the increase in fixed rate fees, but are you seeing these dealers who are then moving up to the fixed rate plan, that they're increasing trading volume, just among those particular dealers, those larger dealers now?

**Tony DeLise** - MarketAxess Holdings Inc. - CFO

Hugh, for those particular dealers, we are seeing an increase in what they're doing. All things being equal, we would probably be better off if they stayed on the regional plan, but with the economics, it does make sense for those dealers to move up to the major plan. It isn't a doubling of volume, but we are seeing an increase in volume, post-migration.



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**Hugh Miller** - Sidoti & Co. - Analyst

Okay. One chart that you did throw in there on slide six was with regards to seeing a sequential contraction in the US high-grade inquiry count. Just wanted to get some color on Q1 to Q2, what kind of was driving that trend?

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

Yes, I think it's totally related to the decline in overall TRACE activity, Hugh, with TRACE down sequentially 15%, but that was really about the first quarter being well above average than it was the second quarter being weak because the second quarter, as I mentioned, at \$730 billion in TRACE volume, was right in line with the average TRACE quarter that we've seen over the last two or two and a half years.

**Hugh Miller** - Sidoti & Co. - Analyst

Okay. You guys provided a little bit of commentary on the financial technology service fees. Obviously up strong on a sequential basis and that you're cautiously optimistic about maintaining that sustainability, but can you just talk about what you're kind of seeing that was driving the strength there? What are the trends for that?

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

Sure. Hugh, on that, as we mentioned, that \$4 million was a historical high or record quarter, and we were careful with the words there on cautiously optimistic, really for two reasons. When you look at the nature of our technology services business, a large majority of those revenues are non-recurring in nature. So upwards of 70% of the revenues are one-time license and technology integration work which has to be generated or re-generated each month, each quarter, each year. We use that as one element of being cautious.

The second part is the customer decision making and spending patterns are really outside of our control. What that means when you combine the two, the non-recurring nature of the revenues, the out-of-control situation regarding customer decisions, it could lead to some choppy revenue situations, but at least in the near-term, where we have greater visibility in the near-term, we are cautiously optimistic on the outlook and sustainability of that Q2 revenue number.

**Hugh Miller** - Sidoti & Co. - Analyst

Okay. Last question I have is just with regards to turning over to the European high-grade business. Just in your opinion, aside from the macro headwinds, which have always been a big challenge, is there anything else that you're seeing aside from that, that really is weighing on growth in that business?

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

Europe is the same summary in second quarter as previous quarters. The sovereign debt concerns are real and they have an impact on credit market liquidity broadly throughout Europe. Those concerns were running at very high levels through most of the second quarter, but also as we've said, our competitive position in Europe is not as strong as it is in the US and we do see distribution currently with electronic volumes across a number of competitive platforms. So, we do need to do a better job in Europe replicating the competitive advantages that we have in the US, which are really built around a unique liquidity pool and unique technology in the US market and we're fast at work on that in Europe, as well.

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**Hugh Miller** - Sidoti & Co. - Analyst

Okay. Thank you very much.

**Operator**

Patrick O'Shaughnessy, Raymond James.

**Patrick O'Shaughnessy** - Raymond James & Associates - Analyst

Hey, good morning, guys.

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

Good morning, Patrick.

**Patrick O'Shaughnessy** - Raymond James & Associates - Analyst

I was wondering if you could update me on the progress of some of your newer product launches, so some of the asset-backed securities, I know you guys kind of thought about or thought over maybe launching trading in municipal bonds at some point. Can you maybe provide a little bit of a status update on those efforts?

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

Yes. Nothing terribly new to report. We continue to add connectivity for asset-backed trading on the system. The numbers were obviously not material enough to include them in the comments that I made earlier about the second quarter success in the Other Product category, but it's following a typical path of adding more dealers and clients and hopefully building the critical mass where that can be a more important product area for us. We also are enhancing the technology capabilities in our structured product areas to be able to also accommodate some of the structured mortgage securities for secondary trading like CMVS and RMBS, so we think that this can be a nice bolt-on to what we're doing in the credit space and we think we're taking the right steps to be successful.

With respect to municipal bonds, we have had client inquiry and interest in adding the municipal bond product. It is something that we're actively considering and we're looking at the GAAP analysis in terms of the work that would be required and we're assessing the client and dealer demand for that market. It's our hope that that will be another area where we can expand over the coming year.

**Patrick O'Shaughnessy** - Raymond James & Associates - Analyst

All right. Appreciate that. A second question I have is getting back to the competitive landscape for high grade US corporates. Certainly, one of the big players on the buy side is going to be BlackRock and there's been a lot written about them moving to an internalized trading system. How do you view that as a threat for you guys? I guess BlackRock, specifically and then maybe more generally if other buy-side firms look to try to internalize more of their fixed income trading flow.

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

You know, I think this reflects the trend that I spoke about earlier, that large buy-side clients need to continue to find alternative sources of liquidity as balance sheets become more constrained at the large dealers. We think in the big picture, Patrick, that's a huge positive for us. We not only have delivered on those alternative sources of liquidity with the expansion in our dealer community, we have lots of technology functionality that will allow clients to expand their connectivity through the MarketAxess trading system. So, we view ourselves as being in a position to be a solution for the interest in broader trading connectivity through the MarketAxess trading system and all signs are that the large clients view us exactly that way.

**Patrick O'Shaughnessy** - Raymond James & Associates - Analyst

All right. I appreciate that answer. Then, quick question for Tony. Tony, as I look at your marketing spend, it jumped up a little bit this last quarter. I apologize if I missed the commentary on it, but can you explain what provided that sequential increase and then, kind of going forward, maybe it's a little too early, but as you would ramp up your CDS capabilities and really try to push that product, shall we be expecting maybe marketing to be one of the faster growing line items as we move into 2012 and beyond?

**Tony DeLise** - MarketAxess Holdings Inc. - CFO

Right. You know, Patrick, certainly it's one of the faster growing items into the second quarter and really driven by two items. We definitely increased the advertising spend and a lot of that is around CDS, so I believe that probably creates a new run rate. The second piece as part of our European strategy, we are doing a lot more cross-selling and there's been a fairly substantial increase in our sales-related T&E, where we're cross-marketing, bringing our European product specialists here to the US to meet with clients and vice-versa, bringing our North American credit trading product specialists over to Europe. So there's been a fair amount of that activity over the last quarter, too. I would think going forward, that run rate that you saw in the second quarter is probably more indicative of where we'll be going forward.

**Patrick O'Shaughnessy** - Raymond James & Associates - Analyst

All right, I appreciate that. One last one, if I could. Your cash balance continues to grow on your balance sheet. Since you didn't really mention it specifically, I'm guessing you have no new capital distribution plans or anything like that, but could you just comment on your view of your current cash balance?

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

On the cash balance, in terms of our priorities, they really haven't changed over the last several quarters, and more specifically on the dividend side, we did increase the quarterly dividend in the first quarter. This is quarter number three at the new dividend rate. Right now, that dividend payout at the new rates, around 26% of free cash flow, if you take out the tax benefit, which I mentioned in the prepared remarks that we have exhausted our unrestricted NOL. When you take out the tax benefits, we're paying out almost a third of that trailing, 12-month free cash flow and just thinking about the parameters that the board set up initially, eight quarters ago, we're right in that range of paying out about one-third of free cash flow. I think in the near term, the board is happy with the dividend level and again, we just changed in the first quarter. the second part on buy-back. We do not have a buy-back in place right now. We have done two in the past four-plus years and I think that's something that the board will continue to evaluate, really, in the context of offsetting the dilution or increase in our diluted share count due to employee equity grants, so that is something the board considers periodically and will do so going forward.

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**Patrick O'Shaughnessy** - *Raymond James & Associates - Analyst*

Great. Appreciate the answers, guys.

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**Operator**

And your next question comes from the line of Howard Chen representing Credit Suisse.

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**Christian Olmbus** - *Credit Suisse - Analyst*

Morning, guys. This is [Christian Olmbus]. I'm in for Howard Chen.

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

Good morning.

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**Christian Olmbus** - *Credit Suisse - Analyst*

Good morning. Congratulations again on a strong quarter. Just two questions from me. Firstly, with regards to the expense guidance. Can you give a little more detail on what's driving the unchanged forward guidance, I mean, despite the \$1.1 million benefit in the quarter, is it just high expenses and anticipated or is this something else driving else driving this?

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

Sure. Christian, on the expense guidance, and you're right, consistent with the view we expressed three months ago, we reiterated our high end of the range expense guidance. I'll go at it two ways. You look at it the first way, you're just looking at our core expenses, excluding new products was around \$95 million last year. Typically we increase expenses around 5%, or 6% or 7% per year. Tack on new products on top of that gets you towards that high end of the expense range and that's one view of looking at the expense guidance.

I think that the second one is a little bit easier to understand. Look at our first half of the year expenses. We're at close to \$52 million in the first half of the year and I mentioned excluding the adjustment for the equity grant cancellation, our second quarter expense run rate would have been around \$27 million. If you use that as a proxy for the new run rate, second half of the year, take the \$52 million from the first half, \$54 million second half, again, gets you to the upper end of that range. Probably the principle driver in there is that we are operating at a much higher performance level, which drives our incentive bonus accrual, so we've got a very -- it's a formula driven accrual and bonus pool operating at higher levels, higher pre-tax, pre-bonus income levels, more fault into the bonus pool and that's probably the single biggest thing driving the offset to what you saw, the offset to Kelley's equity-related adjustment.

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**Christian Olmbus** - *Credit Suisse - Analyst*

Okay. Thank you. And just secondly, maybe a broader, big-picture question here. You spoke to higher capital requirements for banks being a macro-driver for increased electronic trading going forward. Can you help us frame this benefit from a dealer perspective, or put more simply, how do we think of the value proposition your platform provides the dealers from a capital efficiency perspective? Sort of as a way, again, to the kind of margin erosion that dealers should experience as they trade more electronically.



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

Yes. I think the focus is on the cost side of the equation and offsetting some of the drop in ROE through the higher capital requirements by reducing the cost of sales and trading. I think with our fee structure, there's a feeling that for the right kind of flow business in credit, namely the \$5 million and under kind of trading that I talked about earlier, that the dealers can improve ROE if they do more of that electronically, so I think the capital requirements have directly impacted the focus that we're now seeing from many dealers with respect to reducing their costs and they do think the cost structure for flow trades is lower here than it is for phone-based trading.

**Christian Olmbus** - Credit Suisse - Analyst

Great. Thank you.

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

Thank you.

**Operator**

At this time, there are no further audio questions. I would now like to turn the call over to Mr. Rick McVey for closing remarks.

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

Thank you very much for joining us this morning. Enjoy the rest of your summer. We'll talk to you next quarter.

**Operator**

Thank you for your participation at today's conference. This concludes the presentation. You may now disconnect and have a great day.

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