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Virtu Financial, Inc. (VIRT)

Acquisition of KCG Holdings, Inc by Virtu Financial, Inc Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Anna and I will be your conference operator today. At this time, I would like to welcome everyone to the KCG Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

Thank you. Mr. Andrew Smith, you may begin your conference.

Andrew Smith
Senior Vice President, Head of Investor Relations and Corporate Strategy, Virtu Financial, Inc.

Thank you, Anna. Good morning and welcome. Today's call may include forward-looking statements which represent Virtu's current beliefs regarding future events and are therefore subject to risks, assumptions and uncertainties which may be outside the company's control and our actual results and financial condition may differ materially from what is indicated in these forward-looking statements. It's important to note that any forward-looking statements made on this call are based on information presently available to the company and we do not undertake to update or revise any forward-looking statements as new information becomes available.

We refer you to disclaimers in our press releases and encourage you to review the description of risk factors contained in our final S-1 Registration Statement and other filings with the Securities and Exchange Commission. In addition to GAAP results, we may refer to certain non-GAAP measures, including adjusted net trading income, adjusted net income, adjusted EBITDA and adjusted EBITDA margin.

We believe these non-GAAP measures are more reflective of our operations and our core business performance. You'll find a reconciliation of these non-GAAP measures to GAAP terms included in the earnings material with an explanation of why we deem this information be meaningful as well as how management uses these measures.

When used on this call, adjusted net trading income refers to our trading income net of all interest and dividend income and expenses and all brokerage clearing and exchange fees and/or rebates.

Speaking and answering your questions today are Mr. Douglas Cifu, our Chief Executive Officer; and Mr. Joseph Molluso, our Chief Financial Officer. They will begin with some prepared remarks and then turn the time over to the operator to take some of your questions.

Now, I like to turn the call over to Doug.

Douglas A. Cifu

Chief Executive Officer, Virtu Financial, Inc.

Thank you, Andrew, and thank you all for joining us today on such short notice. I'm extremely pleased and humbled to announce today that we have signed a definitive agreement to acquire KCG Holdings. KCG is a prominent and unique franchise that has served the needs of an impressive array of customers for decades. This is a transformative acquisition for Virtu and represents a natural evolution for our company. Our scale, efficiency and advanced order routing capabilities will now be married with KCG's extraordinary client franchise and KCG's hundreds of talented employees and will allow Virtu to accelerate its strategic priorities.

Importantly, this transaction takes place, at what we believe, is an opportune time to be investing in the market making and agency businesses, given historically low points in global realized volatility which are naturally cyclical. Finally, we will be able achieve meaningful cost and capital synergies that will create significant value for Virtu shareholders.

I will go through some selective slides in the presentation that we have distributed this morning and discuss the strategic rational and why this transaction is a unique opportunity that will expand, strengthen and diversify the combined platform and set us up for future growth. I will turn the call over to Joe to discuss select key terms and review detail around significant expense and capital synergies in this transaction.

While on a standalone basis Virtu's role as a leading liquidity provider across asset classes in 36 countries continues to grow, simply put, this transaction will allow us to access for the first time customer order flow in our Americas equities business and accelerate our growth in our agency execution segment.

As outlined on slide four, we will leverage Virtu's scale, geographic reach and micro market structure expertise to interact with order flow that KCG receives from its customer franchise. We believe we can enhance the customer experience and improve profitability by trading more efficiently and using Virtu's advanced order routing capabilities.

Our experience outside the United States where we interact with retail and institutional order flow in a segmented manner is that our execution quality and profitability while interacting with this type of flow is significantly enhanced and we are very excited about the opportunities presented. As you know, offering Virtu's superior routing capabilities and post trade analytics to select buy-side clients has been a strategic priority and we have received tremendous feedback.

KCG has built a marquee franchise in global execution services with connectivity to hundreds of buy-side and sell-side financial institutions and an impressive suite of algorithmic products. These established relationships will provide immediate and significant growth opportunities as we marry Virtu's competencies with KCG's preeminent franchise.

Further, we believe the breadth of the combined company's geographic and asset class footprint will strengthen our position as the leading partner for buy-side and sell-side institutions for infrastructure and agency execution services. We will also generate significant value creation in this transaction. We anticipate approximately $208 million of fully phased-in pre-tax net synergies and a transaction that is over 25% accretive to Virtu's EPS on a run rate basis.

Joe will provide details on these figures including the transaction details in slide five. However, I do want to note that this transaction is financed partially with a $750 million equity investment from a mix of old and new shareholders, including Temasek as well as our new partners at North Island, led by Glenn Hutchins and Bob Greifeld, who are supported by PSP Investments, one of Canada's largest pension funds, and GIC, a sovereign wealth fund of Singapore.

The debt component is supported by a commitment from our partners at JPMorgan to provide up to $1.65 billion in debt financing for the transaction. The participation of the sophisticated global investors in our due diligence and structuring of this transaction is humbling and a tremendous vote of confidence in Virtu.

Following the close of the transaction, I will serve as CEO of the combined company and Joe will remain CFO. We are very excited and look forward to working with the talented, world-class employees of KCG, who share our values and a culture of innovation and we are committed to realizing the full benefits of this transaction.

Additionally, two members of the board of directors will be added to our current board for a combined board of 10. I'm thrilled to announce that Bob Greifeld and Glenn Hutchins will both join us as partners and board members. Both have decades of experience in the financial services area and were pioneers in the first stage of electronification of the U.S. equity market.

They share our vision that, as markets become more competitive and expensive to access, only integrated financial services firms with true global scale will be capable of offering a superior two-sided price to end users and be consistently profitable.

Turning to slide six. I wanted to highlight how the strategic objectives we have identified to create long-term shareholder value for Virtu are accelerated in this transaction. We have said since our founding that our mission is to be the best bid and offer in all of the 235 markets in which we participate in 36 countries globally. This transaction will allow us to move upstream and interact with order flow that prior to this transaction, Virtu was not able to interact with in the United States and offer the enhanced value to these customers. As I noted above, for us, this is an extraordinary opportunity. Virtu has built a thriving business in U.S. equities based on market making without any customer flow.

Now, as we deal in other parts of the world, we will be able to provide Virtu's broad liquidity to wholesale order flow that tends to be non-correlating. So this in no way represents a new business for us. It is simply market making upstream by interacting with segmented retail and institutional and order flow. As a firm, we are very excited about these prospects.

Turning to slide seven I want to point out that this combination we believe will enhance the market making and agency businesses of Virtu and KCG in a way that neither of us could achieve on our own. KCG and Virtu each have unique strengths that can be levered to benefit the wholesale, principal and agency offerings.

Before turning this over to Joe and for Q&A, I want to thank the many team members at KCG and Virtu as well as our respective advisors who helped bring us to this point. In particular, I have gotten to know very well and respect KCG's talented Chief Executive Officer, Daniel Coleman throughout this process and my personal thanks to Daniel for shepherding this process through.

Joe?

Joseph Molluso

Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

Thank you, Doug. I will pick up the slide deck on slide eight which shows the enhanced diversification to our revenue stream this transaction will bring. Based on 2016 numbers, this transaction will increase Virtu's non-market making net revenues from 2% of the total to nearly 20%, an important and strategic diversification.

Slide nine reviews the expense synergies. There will be significant value creation to Virtu shareholders derived from achievable expense synergies. Through identifying redundant operations and consolidating businesses, trading desks, office facilities and other identified savings, we believe we will achieve run rate net expense synergies of $208 million over the first 24 months post closing.

In addition, we believe these efficiencies, which we have identified, will concurrently result in the reduction of capital usage for the combined company by $440 million, which will be used to rapidly pay down debt and return the combined company to its current capital structure on a pro forma basis.

Slide 10 is an attempt to demonstrate the powerful impact the transaction will have on our after-tax earnings. What we have done here is attempt to provide you with the pieces needed to understand how accretive this transaction is to Virtu. When you look at a fully phased-in, in this case – year two of the transaction, in this case, 2019, you see that after-tax synergies, net of revenue dyssynergies, are $129 million.

After applying the proceeds from debt reduction and other cash flows to pay down debt to current combined company levels, we assume an incremental $5 million in interest expense after tax. You can then model across a variety of scenarios for KCG stand-alone contribution, and therefore, we expect over 25% earnings accretion across our range of scenarios.

Finally, I wanted to note on slide 11, the significantly unmodeled upside potential, not including any of the synergy estimates we have shared with you this morning. As you know, with significant volumes, we are able to achieve higher [indiscernible] (11:34) at the venues on which we trade. We can estimate this figure today at $10 million to $15 million.

Given the scale of the combined operation, we will be able to internalize more order flow which will allow greater profitability, reduce transaction costs, and better performance for the end customer. We believe there will be network effects and enhanced trading opportunities from combining both firms' intellectual property. Virtu experienced a similar phenomenon when it merged with Madison Tyler in 2011. The combined business will benefit from KCG and Virtu's work in building out low-latency networks and will benefit from increased order execution efficiency as a result of this.

We believe these elements of conservatism allow us to be very confident that this transaction will be significantly accretive and create value for Virtu's shareholders. We expect to continue to generate strong cash flows from operations. We mention that we will incur an incremental $600 million of new borrowings. At the outset on a pro forma basis at the time of the close, we expect the combined company to have total leverage of 5.1 times trailing 12 months combined pro forma adjusted EBITDA. Including the achievable synergies, this leverage ratio would be 3.3 times, and less than a turn – less than a turn of EBITDA more than we have today. We intend to delever using significant pro forma cash flow as well as the aforementioned $440 million in capital usage to pay down debt. We expect to delever to a ratio similar to our current level of debt within 12 to 18 months after the close of this transaction.

Finally, we've included a synopsis of preliminary Q1 numbers for Virtu. We will announce Q1 earnings on May 4, and have a full press release. The same environment that has impacted KCG's Q1 earnings, mainly historic lows in intraday volatility and realized volatility has also impacted Virtu's results. For the quarter, we expect to report adjusted net trading income of $79.4 million and adjusted EBITDA of $47.6 million.

Getting back to the transaction, we expect the transaction to close in the third quarter of 2017, upon receipt of regulatory clearances and approval and stockholder votes. Once this transaction closes, we will begin implementing the detailed integration plan to bring these two great companies together. Both the KCG and Virtu teams are confident in our ability to consummate a successful transaction.

With that, I will turn the call over to the Q&A phase.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And your first question comes from the line of Warren Gardiner.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

Good morning, Warren.

Warren Gardiner
Analyst, Evercore Group LLC

Q

Can you maybe just dig into the $42 million of revenue dyssynergies a bit more like, kind of where that comes from and what are some of the assumptions that you're – that tie in that number?

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

Sure. I think, it's really to two-folded. And Joe can help you with all the detail, but it's – we assume that there is going to be some books of business that are capital inefficient, if you will, that we will reduce positions and then get out of, and so there is some revenue loss there, but significant capital pickups.

And as well, we assume that there'll be some – in the transition, that there'll be some revenue loss from customers that trade away for a time period but would come back. So, I would argue – and I would think that those numbers are conservative, but we wanted to make sure that they were included in the model from the get-go. We think we can ultimately outperform that, but we wanted to be conservative with our revenue dyssynergies. Joe?

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

Yeah. That's right. I mean, we are trying to be quite conservative. As Doug said, as we look at businesses where capital does not – the current level of capital is not supported by the profitability and obviously we dug into all this in due diligence, we want to be – part of the good thing about being in this business today is that we feel we can migrate a lot of the revenues and obtain the capital efficiencies. But we're trying to be very conservative around that. So, we've made some very, very detailed bottoms-up assumptions, and it's across a variety of desks and – that generate that number for them.

Warren Gardiner
Analyst, Evercore Group LLC

Q

Okay. Thank you. And then, I guess obviously some real benefit from moving upstream on the retail front. I mean, any sense [ph] how should we be (16:24) thinking about I guess sort of the accretions of the capture rate, if you will, in Americas equities? And then, also maybe some color on – sorry, in Europe, I know there was sort of an effort on KCG's front there as well with respect to retail over there?

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

Yeah. It's a great question. And as I tried to note in my prepared remarks, this is not like a new business for us. Really what happens globally is you have segmentation of order flow, and it's done by different mechanisms and different regulatory regimes. In the United States, you have this well-oiled machine, if you will, some people call it payment for order flow or wholesale market making, whatever it is. And in Europe and in Asia, it's done differently. So, we participate in segmented markets globally in Europe and in Asia, in particular. And in those markets, while we don't disclose individual capture rates for an all-to-all market as opposed to a segmented market, we can tell you this, episodically, if you will, and obviously we track this by venue and by strategy, that there was a meaningful difference as to how our strategies perform not surprisingly when they're not in all-to-all market, but they're in a segmented market.

And so, translating that to the United States and to the KCG business, we're obviously very optimistic that having access to that order flow with our partners and in new friends at KCG that we can significantly augment the experience that the customer has and also maximize our profitability as we interact with that flow.

I would also point out that the thing that we have done very well as a firm is really hone our entry and exit of positions. When you don't have the benefit, if you will, of customer and institutional order flow when you're fighting in the all-to-all market, you better be very acute and very good around technology, understanding market structure. And you have to have a low-cost environment. That's really been the Virtu's story, right. We don't have a competitive advantage in terms of having institutional and retail order flow on a large-scale basis. And so, we've spent the 10 years, since we started this firm, really doing that. That's the DNA of this firm, micro-market structure scale efficiency.

KCG comes at this from a different point of view, right, which is they have got this great customer franchises, institutional and retail franchise that they've had for two decades, and they do a fantastic job at it. In due diligence and just around the market, they're kind of the platinum standard, if you will, for customer service. And so, they're providing a service on the market making side. And we're providing a service, if you will, in the market making side. And they are coming from the north. We are coming from the south. And we're sort of meeting at the equator, right, because at the end of the day, you've seen this conversion of technology and efficiency in the marketplace. And we think by combining the two, we're going to get 1 plus 1 equals 3. And that's really kind of the main strategic rationale for doing this. Certainly, there's a lot of financial components, and Joe will go through all those. And we've put a lot of those in the deck. But strategically, this is a very important transformative situation for Virtu. I also would say, on the agency side, you mentioned Europe, one of the key motivators for us wanting to get into the agency execution business was obviously our experiences with order routing for our own self, and how that value proposition really translated to the agency business. Now, with the advent of MiFID II and unbundling, it just seems like the time is really right for a superior execution-only agency offering really to be well-accepted by the buy-side.

And, again, through our due diligence and understanding the market and talking to customers and whatnot over the years, we have a great deal of respect for the products that KCG has. We develop some of our own products, some of our proprietary QCA and transparency products into the way that we route. And we think, again, by marrying their great institutional client base and the great talents and skills that they have with our technologically-advanced, if you will, order routing capabilities, again, we think on that side of the house we can develop a terrific product as well.

Warren Gardiner
Analyst, Evercore Group LLC
Q

Great. Thanks. That's really helpful. That's really helpful color. I think, just last one for me. I think the answer is no, but should we be thinking about any change to dividend as you guys are sort of delevering or not as related but the tax structure as well?

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

Yeah. No. Great question, though. So tax structure will stay the same and I think we've put in the press release that there's no plan for change of dividend as well. That's, obviously, we've...

Warren Gardiner
Analyst, Evercore Group LLC
Q

Okay. Yeah. I understand.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

...dealt with that in the capital structure and our partners at JPMorgan is formulating the credit to make sure that we have the ability to continue to pay the dividend.

Warren Gardiner
Analyst, Evercore Group LLC
Q

Great. Thanks a lot. Appreciate it.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

Thank you, Warren.

Operator: [Operator Instructions] Your next question comes from the line of Alex Kramm.

Alex Kramm
Analyst, UBS Securities LLC
Q

Yeah. Good morning, everyone. Just wanted to come back to you guys entering the retail market making space. Maybe you've mentioned this at the beginning but, obviously, you're entering this business at a time where there's lot of price competition at the end markets. You're seeing Schwab and others low on fees a lot and obviously that's a lost revenue opportunity for those guys and you could argue that at some point that could trickle through to the market making community. And in particular, if you think you're going to make more money in trading the order flow, some of those guys might want to share the upside. So how do you feel comfortable that that business not a race to zero in particular if there's competition at the end market?

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

Yeah. Look, it's a great question. I think the way we do business is to be transparent and collaborative with our business partners. We've done that throughout since we started Virtu so, obviously, I need to get to know these folks, I know some of them very well and I know the great folks at KCG that have interacted with them for years have a terrific relationship with them. I think this is a win-win for those customers because at the end of the day we're going to bring the efficiency and scale that Virtu is known for to that business, and so we can make that a more efficient business and make it a better experience.

At the end of the day, is there going to be an adult conversation about how is that shared and ultimately how does the end user, the retail and the institutional investor that are using the services of a Schwab or et cetera, how are they going to benefit from this. That's really the most important thing. We think we can drive execution quality, we think we can continue to reduce cost because that's kind of what we do. We've been one of the proponents of competing at lower spreads and dealing with rising costs in a competitive all-to-all market. So we think that this is a key moment in time for this segment of the business to get more efficient and to hone its skills. So, look, at the end of the day we're all adults, we're all in the business to make money, but at the end you need to provide a superior product to the end user and I'm very confident that this will be a win-win for the fantastic customer base at KCG.

Alex Kramm
Analyst, UBS Securities LLC

Q

All right. Thank you. That's helpful. And then just secondly, I guess it's for Joe. Can you talk a little bit more on the technology synergies and the road map there? I don't know KCG that well anymore, but I feel like there were a lot of acquisitions and, obviously, Getco-KCG coming together a few years ago. But from what I understand, not much was integrated. Maybe there were, like, four different trading platforms or more. So where are you heading? I mean, is the road map defined already? Is it going to be a Virtu backbone over time or is this one of those situations where we wake up and you actually realize you can't integrate as much because you don't know what happens when you shutdown one system and there's a lot of risk involved. So how comfortable are you with the technology road map? And, actually, what are you seeing there internally that might be very inefficient?

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

Yeah. Look, when you look at how we've detailed the synergies, we broken out $70 million of technology, communications, and data processing synergies. The first step there is just kind of indentifying redundant telecommunication pads around the globe, and KCG's done a great job managing that and I think we've done a great job managing that. And this is an area where you can literally look at contracts and services and data contracts and what they pay for market data and what we pay for market data, and there are just direct redundancies there. And that's what represented in that number. So that $70 million that we've called out is just cost savings associated with redundant technology, infrastructure, data processing, that we think is very achievable. It's very similar to what Virtu did when it acquired Madison Tyler in 2011.

I think to your point though about the overall technology platform and systems, I think that will be a phased process. I think, ultimately, the goal is to have one technology platform but there are a lot of different areas to look at and I think they'll be benchmarks within 6 months, 12 months, 18 months, 24 months. But I think from the customer experience at KCG, there's not going to be anything that changes in the near-term or the intermediate term, like there will be no overhaul of technology immediately that will change anything related to the important customer franchise.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

Yeah. I think that's the most important point that Joe just made which is as far as the customer experience is we get how important that is and that the interaction with the KCG environment right now is superior and we don't want to change them. What happens behind the scenes if you will ask behind the wall, we've really always pride ourselves as you all know in having a single integrated platform that's multi-asset class, multi-currency, and all of our offices and the way we operate are 100% seamless and interchangeable. We're going to bring that scale and efficiency to what KCG has to offer to the customer. That'll be behind the scenes, if you will, but absolutely at the end of the day that's why we have been able to be as successful as we are in terms of having a scaled plan.

Alex Kramm
Analyst, UBS Securities LLC

Q

Okay. So if I hear you right, the $70 million technology savings is really just the, I guess, the duplication in end market data and there should probably be upside if we actually end up cleaning up the backbone? Did I hear you right there, Joe?

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

It's duplicated market structure and it's duplicated your telecommunications. Yes.

Alex Kramm
Analyst, UBS Securities LLC

Q

Okay. And then just one quickly at the end here as well. In terms of the leverage, you said you can delever quickly. What do you think, long-term, this company should be running at in terms of leverage? I don't know if you mentioned that.

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

I think that today we're around 2.25 to 2.5 times and that's where we expect it. So basically if you look at our leverage profile today, we did a refinancing of our debt in the fall and our message was that this is the right long-term leverage level for the company. And I think what we've identified as a 18-month path where we can return to that proper capital structure.

Alex Kramm
Analyst, UBS Securities LLC

Q

All right. That's it for me then. Thank you.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

Thank you very much.

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

Okay.

Operator: And your next question comes from the line of Christian Bolu.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

Good morning, Christian.

Christian Bolu
Analyst, Credit Suisse Securities (USA) LLC

Q

Good morning. Apologies if I missed this, but could you talk about what the cost to achieve synergies and fully integrated KCG are?

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

Yeah. The cost to achieve synergies here, we haven't outlined them. We will naturally be, as we achieve these synergies around telecommunications, around occupancy, and leases, we're going to be having kind of a one-time write-off. So we haven't fully identified the total charge and separate that between cash and non-cash. But I would tell you as a rule of thumb, something that is in between 50% and 100% of the fully phased-in run rate as a one-time charge would not surprise me.

Christian Bolu
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. And that's a cash charge?

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

No, it'll be cash and non-cash. It'll be cash and non-cash.

Christian Bolu
Analyst, Credit Suisse Securities (USA) LLC

Q

Maybe in terms split of cash and non-cash? I'm really trying to focus on understanding the cash bid.

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

We'll be providing more detail on that. I think the non-cash part will be the greater number. The non-cash part will be the greater number just because as you capitalize long-term leases and as you capitalize real estate and things like that, those numbers tend to be bigger. And then as you cancel contracts or if you have any reductions in force, the way we've modeled it anyway, that's the smaller part of it, and those tend to be cash items.

Christian Bolu
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Thank you. And can you just help me understand why you raised $715 million in equity and $1.65 billion in debt to fund a $1.4 billion deal? What's the delta between...?

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

We're refinancing so the delta is the two companies have $1 billion of debt on them today, so we have to refinance both of those pieces of debt. And so the incrementals, so you have your numbers, Christian, but just think of the debt as an incremental $600 million.

Christian Bolu
Analyst, Credit Suisse Securities (USA) LLC

Q

Got you. Okay. That's helpful. And then the 25% accretion. Just so I'm clear, that doesn't include debtors' factor and the impact of the equity offering, right?

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

It does. It does.

Christian Bolu
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Perfect. And then just lastly, and I think you just talked about this earlier on, I guess one could argue Getco had exactly the same pieces, all very similar pieces to you when it took on KCG, and profitability has been somewhat tough. Maybe just help me understand very big picture what's different this time? How you'd approach integrating Knight to come to a better or a long-term outcome?

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

I wasn't there and I have no real idea. Obviously, I read some of the news clippings and things like that that you did. All I know is how we operate and how I'm going to approach this transaction. And to be blunt, we have a lot more to learn from KCG than KCG has to learn from us. These guys have been in a tremendous business and have served the market ably for two decades. And so we're going to in there very humbly and say, guys, we really want to understand how you all operate. We think we can help you make it better and let's be collaborative and work together.

We are a lean and mean management team here. It's Joe, myself, and some other folks sitting in this conference room. We're not going to go in there guns blazing and say, it's our way or the high way. We're going to go in and really try to learn and be collaborative. I am 100% convinced that there are literally hundreds of very, very talented people at KCG that will kind of get the way we want to run this business. We'll be excited about creating a truly integrated financial services firm. And we think that we can build the best in class market making and agency business that can be competitive and that can be sustainable and can provide a better customer experience. And most importantly, for our investors, we'll continue to drive significant margins and profitability.

So that's kind of the best that we can do which is to be humble, to try to learn and try to get the best out of both firms and integrate them in the right way. We had the experience to doing that with Madison Tyler which was a very significant market making firm that we merged with in 2011. And the most important thing that I learned from that transaction is it's not us and them. It's not Virtu and Madison Tyler, it's us. And so, at the end of the day, it's not going to be Virtu and KCG and I don't care where you came from. The best people will be promoted. The best people will be on the management committee and the best people will continue to grow and learn with the firm as I will. So we're really looking forward to the experience.

Christian Bolu
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. Thanks very much for the detailed answer.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

Thank you.

Operator: And your next question comes from the line of Chris Allen.

Chris Allen
Analyst, The Buckingham Research Group, Inc.
Q

Good morning, guys.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

Good morning, Chris.

Chris Allen
Analyst, The Buckingham Research Group, Inc.
Q

Apologies if I missed some of this and is redundant, but just a couple of different questions. One, the 25% accretion, is that off of fiscal 2018 or 2019. I'm just trying to [indiscernible] (33:40).

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

The way we presented here in the deck, Chris, is really what we've tried to do is, say, look, you have your own view of Virtu, you have your own view of KCG, no matter what scenario you model, the moving pieces are going to be kind of what are the net cost savings and what is the incremental interest expense.

So, naturally, if you modeled it right out of the box where you know we haven't paid down that debt in the first quarter, it's still accretive. But what we've done here is, say, look on a fully phased-in left to right capital structure scenario, it is over 25% accretion. So the example we've given on page 10, said, it's 2019, we chose 2019 just because it's the full second year. We're assuming we close in Q3. But it doesn't have to be. You can pick any year, you can plug in any numbers you want that you'll come up with for KCG and Virtu and when you plug in the synergy number even with higher amounts of incremental interest expense, it is meaningfully accretive.

Chris Allen
Analyst, The Buckingham Research Group, Inc.
Q

But using 2019 consensus, is that right for the 25%?

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

Yeah, I mean, if you plug in 2019 consensus, I think you're going to get something even higher.

Chris Allen
Analyst, The Buckingham Research Group, Inc.

Q

Okay. And then just kind of the – I know it's two years before phase-in synergies. Just trying to think about how to kind of let that in over those two years, kind of I mean, how long does the development work needed on your side to be able to implement the KCG strategies. We'll be utilizing some of those. I'm just trying to reconcile that kind of make sure without going too quickly in terms of the synergy build outs?

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

I think just in terms of the actual number that we've put out there Chris, a simplifying assumption that would work is just 50-50. 50% in year one and then a 100% in year two.

Joseph Molluso
Chief Financial Officer & Executive Vice President, Virtu Financial, Inc.

A

Yeah. And Chris just a little more color on. I think there are a lot of things that are going be day one like we obviously don't have to pay my favorite topic, market data fees and things like that. Those are day one tiering benefit, those are day one consolidating flow within legal entities to reduce brokerage costs. Those are all day one. We've a lot of experience from having done that in the Madison Tyler Virtu transaction where we saw a lot of those day one synergies.

Obviously coming telecommunication lines and colos and what not reducing footprints, migrating strategies onto a single box, so that you can reduce a footprint at a very expensive collocation. Those aren't necessarily day one, maybe they're day 30, they're day 90, depending upon the term of the actual lease or colocation facility, but they're easily identifiable.

In terms of technology and replatform, what I would point out is that, here at Virtu, we have a lot of experience, being a technology service provider. We have an arrangement with a large financial institution on the FX side and then our much [indiscernible] (36:54) arrangement with JPMorgan, where effectively we are routing risk for JPMorgan in the fixed income world and the U.S. treasuries world, right. So it's not entirely dissimilar to the situation that we're going to be faced with, from an architectural perspective in the KCG environment, where they've got this great host of strategies that are very, very complementary to what we do in the customer market making segment.

They access the market in a pacticular way. W are very good at accessing markets, we're really fundamentally a terrific smart order router as a firm. So taking those intensions, those orders from KCG and routing them through a Virtu environment is something that will be very high on our list and we have real time experience, if you will, by doing that as a technology provider, already with our friends at JPMorgan. So they were a terrific test case in terms of how do you access the market when your strategy, if you will, is now actually coming up with the idea to place a particular order on a particular side or a particular product.

So it's going to a take a little bit of time to do that, but we're very confident in our ability to do that. We're already done that. As I said before with Madison Tyler, and we've done it with large global financial institutions. So, in looking at the architecture of KCG, we think we can get that done relatively quickly.

Chris Allen
Analyst, The Buckingham Research Group, Inc.
Q

Got it. And then, just a little bit on the $440 million of capital synergies, you talked about rationalizing non-core businesses. Does that include a potential sale of BondPoint?

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

No. And to be blunt, I mean I don't know a lot about BondPoint other than obviously what I've read. I haven't have met the people and strategically I have to really understand how it fits into their customer base, and how it makes sense. I mean it's a terrific asset. Obviously, I don't know if they do separate financials on it, whatnot. So I'm not going to talk about those here, but the results that I have seen and the growth that I have seen is really a terrific asset and a great product. I understand the market somewhat in terms of credit and credit platforms. I think it's a market leader in what it does. I think it's got a lot of potential. Can we augment the customer experience [ph] test (39:05) through technology, through this, that or the other thing, I'm not sure. But Joe, myself, the guys at Virtu, we'll be very collaborative with the folks at KCG that have the most experience, and in particular, we never want to do anything that has any impact at all in the negative fashion on the customer segments they have.

So do their customers rely on it? How important is that? So we're going to make that strategic assessment. All I know is it's a very, very, impressive asset and these guys have done a great job running if they really have.

Chris Allen
Analyst, The Buckingham Research Group, Inc.
Q

Okay. I mean putting that aside, the $440 million of capital synergies seems like a pretty big number to me. [indiscernible] (39:42) down between the three bullets you kind of listed on page 12 like what's – how that's broken down between those just I mean, if we were to do [indiscernible] (39:51) get their very easily. But I'm kind of questioning that number now a little bit.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

Yeah. So, just to complete the BondPoint actually, BondPoint really doesn't use any meaningful capital.

Chris Allen
Analyst, The Buckingham Research Group, Inc.
Q

I know. It just could be sold for decent amount of money so.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.
A

Yeah. So – no, no yeah. So that's not included here, and look [indiscernible] (40:15) is kind of in the very, very detailed due diligence. But there are a number of areas. We've got consolidating businesses within Virtu. I think what that means is kind of we got legal entities, regulated legal entities in Europe and in Asia and in the U.S. as they do, right. So you achieve capital synergies when you move business into our own legal entities.

We've got a separate legal entity set up for proprietary trading and agency trading in Europe, right, we're going to achieve capital synergies there. There are a number of things that we've dug into in terms of how much capital is used to support different desks and different businesses that are going to be consolidated or rationalized and we've done a very granular, very you know kind of position by position, bottoms up analyses of capital usage and the impact on revenue. So some of that revenue dissynergy is a result of this, but we've applied a very kind of Virtu like wins, in terms of appropriate returns on capital and this is what we've come up with.

Chris Allen
Analyst, The Buckingham Research Group, Inc.

Q

Got it. Okay. That's it from me, guys. Thanks.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

A

Thank you, Chris. I think, operator, any more questions? I don't believe there are.

Operator: There are no further questions at this time, sir.

Douglas A. Cifu
Chief Executive Officer, Virtu Financial, Inc.

Great. Thank you, everybody. We appreciate everybody assembling on such short notice. And again, we really look forward to continue to discuss, how this important and accretive transaction will evolve Virtu and for the – for my friends at KCG, I will be down there later today. And I look forward to meeting a lot of you in person. Thank you all.

Operator: And this concludes today's conference call. You may now disconnect.