Focus Financial Partners

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Unidentified Participant: Thanks for joining our next session. I'd like to welcome Rudy Adolf, CEO and Founder of Focus Financial and the firm's CFO, Jim Shanahan. Focus is a leading RIA franchise that has experienced significant growth over the years, capitalizing on the many structural drivers in the wealth management industry, despite what's been, of course, a tougher backdrop so far this year.

Focus continued to execute on its growth strategy, announcing 24 transactions this year and delivering north of 20% EBITDA growth year-to-date. We look forward to getting an update from Rudy and Jim on how the firm is navigating today's environment and of course get your thoughts into 2023 given the time of the year. So thank you both for being here. Always great to have you.

Ruediger Adolf: Thanks for having us.

Unidentified Participant: Or actually, welcome back as we were saying earlier. We missed you last year because you had your Investor Day on the following day. So you had to skip but not this year. So look, maybe we could start with a couple of questions around the M&A environment and the deal activity in the RIA industry. And the first question I have is really 2023. We've seen a pretty tough backdrop in this year. You guys still managed to announce a pretty healthy number of transactions. So what are your current dialogues like with prospective targets? And what is your outlook for deals into 2023, especially if markets remain somewhat volatile here?

Ruediger Adolf: Yes, absolutely. Well, you said 24. It was last week we announced 28 deals year-to-date, of which 6 are partner firms, 22 are mergers. So we had a terrific year. And it's not just the number of deals. The way we look at it is, of course, is capital deployed is the quality and diversity of the deals that we are doing. And we are not fully done yet for this year. There will be some more announcements.

And the way we look into next year is momentum is terrific. I said this last year on Investor Day. Basically, this industry is not in consolidation in this industry, our M&A business is not really dependent on whatever market volatility. It's ultimately fundamental drivers that, first and foremost, it's the aging of the founding generation in this industry. It's the benefits of scale from an adviser firm economics. And quite frankly, it's ever increasing needs of the client that really drive scale, the need for scale and be a facilitator of scale. So a fantastic year in 2021, our best year ever, 38 deals. Year-to-date, we announced 28 deals, and I'm very optimistic as we look into next year.

Unidentified Participant: Yes. Let's spend a couple of minutes on deal economics and really the impact of rising interest rates on how that impacts financials for the type of transactions you guys do. So spend maybe a couple of minutes on what returns you're currently underwriting to in today's environment? And does this regime change impact your deal funnel in terms of the prices you were able to pay, which could let some companies pull out of the opportunity set.

Ruediger Adolf: Yes. Actually, we always publicly disclose here, we use a 20% hurdle rate. Your typical returns that we generate are 25%. Over half of our deals create returns well in excess of 30%. So basically, whenever we deploy capital, we create very, very attractive returns. And you know what, financial theory hasn't been abolished. Rates are up, multiples are down. So reality is we really like what we see from a multiple dynamics perspective.

And quite frankly, what is unique for the deals right now, probably next year is because we ultimately buy on the run rate. So in reality, of course, run rate just based on market dynamics are impacted. So we have an embedded tailwind in every deal that we currently are doing when things normalize, they will normalize at one point, who knows when, but they will, that ultimately, we believe this current vintages of transactions are probably going to be some of the best we have ever done, which is why this is so important for us to sustain the deal momentum. And we clearly are demonstrating this. I feel very good about next year.

But one opportunity that we currently have, and we announced this during the third quarter earnings call, is basically that we can now, because of a lower competitive intensity in the M&A business, we can now structure deals where the upfront multiple is basically accretive to our current leverage target range. That is really attractive and that really allows us to continue doing what we are doing and ultimately deploying capital at very attractive returns for years to come almost independently where our balance sheet may be at a given point in time.

Unidentified Participant: We'll spend a little bit more time on deal structure. But before we go there, I was hoping we could just touch on the competitive dynamics in the landscape there that you mentioned. So clearly, we've seen a lot of new players coming into the space, paying very aggressive multiples in the RIA industry over the last couple of years. How much has that changed? I know you mentioned the purchase multiples have come down. So hopefully, it's partially a reflection of fewer competition. But how has that changed? And I guess how permanent is that?

Ruediger Adolf: Yes. What's interesting is year 2021, there were some new players coming in. And Alex, it was a little bit amateurs hour. There were people paying just insane multiples. Guess what? They use their powder and fundamentally are not a factor in '22 and in my judgment, probably in the future. So there is this rationalization that we are seeing. And to some degree, even when like in 2021, it was foreign players, asset managers and others who just don't have the competence in this industry in reality and ultimately, overpaid it massively. It didn't really impact us that much directly. We still did 38 deals. We deployed more capital than ever in our history at very good multiples. Why can we do that? It's the uniqueness of our value proposition.

Ultimately, firms join us, you want to be an entrepreneur. You want to have access to real tangible value-added capabilities, tried and proven and you want permanent capital. Focus is the only game in town. There are others with different propositions. And obviously, we don't have this industry for ourselves. But it is so differentiated. And in the core of our proposition, there's really nobody else, which basically allowed us to have a very successful year in '21, have a very successful year this year. And the way I'm looking into next year, I feel very, very good about the future.

Unidentified Participant: Great. Let's talk about capacity first before we kind of get into some of the deal structure. So you're currently at the upper end of your 3.5 to 4.5 leverage target. So one, I guess, let's talk a little bit about your commitment to stay within the range if the deal activity continues to come through. And what does that really mean for your -- if you wanted to expand the capacity, where would that come from?

James Shanahan: So obviously, our target range is 3.5% to 4.5%. Last year, we did over 30 deals. And this year, we've signed or closed 28 deals at this point in time. Earlier this year, what we did, we amended our credit facility for the revolver to change the maturity date of the revolver to June of next year -- I'm sorry, June of '24. So at some point, we were going to refinance our credit before June '23, so it wouldn't be current.

So what we did late November was we re-amended our entire credit facility to push out the maturity dates on that, but it was also to reset the dry powder for our M&A activity. We continue to operate within the range of 3.5% to 4.5%. As Rudy said, we structured the deals. Accordingly, we're be able to transact on that into next year and future years. But one thing that gives us the capital is the credit facility that we just did. So we've reset our $650 million revolver, which is a 5-year maturity date out to November of 27th.

We added a new term loan for the first time, a Term Loan A, $240 million. It was supported by many of our long-term lenders, including Goldman Sachs. That has a 9-month delay draw, so we can pull down that credit when we need it for this M&A. And then from our term loan B perspective, we increased the size of that by about $162 million. So when you add up those three instruments, $650 million, $240 million, $160 million, we have over $1 billion of dry powder here. Not to mention the cash flow that we generate. In the recent earnings call, we disclosed $346 million of LTM cash flow available for capital allocation. So we can redeploy that into the business as well.

We selectively use equity. We primarily use cash as our consideration, but that's always an alternative to when we look at our leverage metrics. So we've taken the refinance risk up to the payable. We have over $1 billion of dry powder. We generating a lot of cash flow. We're tweaking our deal economics to continue on the growth path and remain within this leverage range.

Ruediger Adolf: If you think about it in the context of what we said before, over 50% of our deals create returns in excess of 30%. The impact of this credit work that Jim is talking about is basically after tax about 230 basis points. And we entirely eliminated any refinancing risk. So what it really speaks to is, A, the quality of our balance sheet and how easy it is for us to really take advantage of it. But B, is kind of how we are looking into the future and really making sure we have the capacity that we need to sustain the M&A momentum.

Unidentified Participant: Great. Let's talk about sticking with the deal structure topic for one more minute. Let's talk about the deferral structure that you guys started talking about on the last call. In a way that really kind of decouples the ability to do deals versus the leverage constraint because you're still trying to be within 3.5% to 4.5%. You're at the upper end of that. So intuitively say, well, you can't really do a whole lot more. This kind of gives you more flexibility. So can you walk us through how that works and what percentage of deals you ultimately expect to come through this deferral structure? And really the client or the target response to that? Is that something they like? Is it something they'd rather not have? How does that work?

Ruediger Adolf: Yes. Yes. One reason it is relatively easy for us to implement this. It's actually good news for the seller and it's good news for us. When we started Focus on my kitchen table in '06, we kind of were a financial (inaudible). Meaning every time we did a deal, it was usually below our leverage range. So every deal created the capacity for the next deal.

Now those days where we had a lot of paper and not much cash, every deal had to be 50-50. And of course, the partners who came in just did really, really well. We started this business at $1.42 per share.

So we use some of the same techniques. You're just not using equity. So what we are now doing is basically many of the deals, the upfront consideration is below our leverage target range of below 4.5, which is based on the initial purchase in 10, 3, 4, 5 years later, basically true it up with the other half of the purchase price.

It's actually relatively easy to negotiate because we are buying on a run rate. So when you're buying on a run rate per definition in the current market, you've got headwinds. So your run rate is down. So what it does is it creates an alignment between the seller and us were when run rates improve, which they probably will at one point, certainly, hopefully, in the next 3, 4, 5 years, they get the benefit of an improved run rate, we get the benefit of deferral, which in effect, this is a big deal when you think about how we are deploying capital.

Deals now are at least neutral to leverage. Some of them are accretive to leverage, creating -- putting us back into the financial (inaudible) days that we started. And this in an industry that will continue to consolidate, in an industry where you've got some softening of multiples, in an industry that by definition will have these tailwinds that will kick in at one point. It creates a terrific opportunity for us. And that is one of the reasons why I'm really so optimistic about 2023 and thereafter.

Unidentified Participant: Great. All right. Let's shift gears a little bit and pivot from M&A and deal activity to organic growth. So market is obviously challenged. If we look at the lower equity and fixed income markets on the business, naturally, there's going to be some mark-to-market effect and that flows through your financial model. But if you kind of peel that back and you look at the organic growth at your partner firms, excluding markets and excluding any kind of firm level M&A they do. I think in the past, you talked about that being sort of in the mid-single-digit range. How has that been tracking so far this year? And what sort of the outlook you're getting from that kind of true organic growth from your partner firms into next year?

Ruediger Adolf: So as you know, the average Focus partner firm grows almost 15% a year. You take out -- well, Focus as a whole empirically has grown at 30% a year. And our partner firms, roughly 15% a year, we disclose this every quarter. You take out the M&A business, you were at about 10% same-store growth. This is basically a market impact. Market impact is very easy to estimate. You look at the typical performance of a 55%, 45% portfolio. And this is usually in the kind of mid-single digits. And the delta is true core growth the way you would think about it, which is ultimately more money from existing clients, minus distributions plus money from new clients.

And this is actually a relatively consistent number over time. Yes, it is currently lower than what you would typically see simply because there are not enough liquidity events. We are primarily in the ultra high net worth and high net worth segment. And therefore, a very important driver of our core growth is more money from existing clients. More money from existing clients means people sell their businesses, people exercise option positions, concentrated stock or similar. And this obviously is less active in a market like this.

So really going back to what we discussed before. This will turn around at one point. And this then speaks to the embedded momentum that we believe we have in our existing portfolio and with new transactions. So when there is a change in sentiment, quite frankly, this is when these forces that, of course, are driving us down today come back with a vengeance. And that's really the embedded opportunity that we see, and it's going through every single component of our business model, including core organic growth.

Unidentified Participant: Understood. Understood. Some of the things we spent talking about in the last couple of years now are some of the capabilities that Focus brings to your partner firms in an effort to really accelerate their organic growth, right? Because you guys don't charge for them explicitly as part of the model, you benefit when your partner firms benefit. So whether it's things like tax insurance, alternatives, et cetera, and all the things you've been rolling out, it sort of meant to accelerate the organic growth. So maybe talk a little bit about how the uptake of some of these services has been? And any evidence you could share with us how that ultimately accelerates organic growth at the partner firm level?

Ruediger Adolf: Yes. Yes. So really, the purpose of Investor Day a year ago is to explain that I grew up a professional at McKinsey, so I think in S curves, we're jumping to the next S curve. When you started a business, there was proof-of-concept, rapid growth. Now we enter the stage, how can we take advantage of this unique growth that we have in this industry globally to ultimately create a better solution for the end client to create a better solution for our partners and of course, ultimately benefit from this shareholders.

And really what is driving these activities today on the client-facing services, what we call Focus Client Solutions, it starts with alternatives, access to superior alternative solutions that many of our partner from simply could -- would not have with us being a partner in Focus. It is access to cash, access to credit, trust services, P&C, life insurance. At one point, we'll be talking more about multifamily office services that will be part of this. And all of these are about bringing the best that the market can offer to the end client by leveraging this unique scale that we have.

To give you a couple of kind of data points. Our alternative program we launched very recently, maybe it's 18 months or so ago with our partner from SCS, if you want to build powder (ph) in the program, at this point, they have over $300 million of capital already managed. There's another at least $0.5 billion of commitments. That's just from within opening up their strategies, this will be soon $1 billion.

These are very big numbers in the world of alternatives in the RIA space. Credit since the inception of the program about 2 years or so ago. We have worked on $3 billion of credit in an advisory capacity, where again, it's not our balance sheet. But we use our unique scale to provide superior access to a network of, I guess 60 banks at this point who are specialists in different areas.

So strategically, we really brought the concept of open architecture to the world of private banking. This has never been done before and doing this with the depth and the excess of, yes, arguably, by distance, the largest player in this industry. This gives us a competitive advantage and ultimately, an advantage that really touches the end client directly in a way that certainly has never been done before. And that helps us better serve clients. It helps, therefore, with organic growth. It helps with M&A because it is a core component of our value proposition. So it is literally this next S-curve that Focus is entering, and it's still at an early stage, but there's tremendous scale opportunity.

James Shanahan: Yes. Our advisers expect more clients that are constantly expecting more. We just had some investor meetings this morning, and we were given 2 tangible examples. There was a large wire house adviser who recently left ultra-high net worth and was critical to that transition was to have credit capabilities for the clients to come to the RIA channel. We're one of the few that can offer that capability. If we didn't have 10 specialists in credit, that transaction would never have happened for our partner firm down in Atlanta.

Likewise, one of our MDs just was working with our partner in the West Coast and it was sort of a competitive transaction. And what the client was really looking for was a one-stop solution for all of the state plan and trust solutions and so forth. And we brought that to the table and the client joined us. So it is still early days, but these value-add services are really starting to resonate in different ways across the partnership.

Ruediger Adolf: Maybe one more example just to bring it to life. Yesterday, I talked to our prospect. He's spending probably $200,000, $300,000 just on P&C insurance. He's probably underinsured. He probably should be doing more. He's doing it with one of the big writers and the ability to have objective advice, objective from a fiduciary to really help him, well, maybe this is the right rider for this. This is, this here, you have a hole here. When he talks to his broker today, well, all he wants to do is sell him more insurance. So when you are in the complexity of financial life and you have access to these capabilities, whether it's P&C insurance, life insurance, credit, trust any of these areas, where else can you get this type of service? That's really differentiating.

Unidentified Participant: Right. Let's keep moving down the list of some of the strategic initiatives you guys have been focusing on. Connectus is definitely one of the bigger ones that I think really resonated with a lot of investors when you rolled that out. So maybe walk us through kind of how this offering is performing in current markets. And maybe providing us sort of with an addressable market that you think exists for something like that?

Ruediger Adolf: Yes. So Connectus in many ways, was a missing link. We had our thriving merger business. We, of course, have the holding company deals, but we needed a proposition that is kind of in the middle, with shares, infrastructure shares capabilities. And therefore, quite frankly, is a higher margin business here for us. And this is what Connectus is proving to be. It is already growing at extremely high rates. It will be one of our largest partner firms in a very short time frame if you kind of use a partner firm framework. And at this stage, of course, we just announced it recently, it's still about getting the platform right, hiring the right people, starting it on a very robust foundation.

We have it in Australia already quite well established. We have it in the U.S. There are some other markets where we are going to scale it. So still early days. We like what we see. It proves the concept that is going to be a higher-margin business. And we still have to see a little bit when is it the right answer and it's not a merger when it's not a holding company deal. I think this will evolve over time, quite frankly, over time, we probably will have existing Focus partner firms who will look at this as a very attractive platform and simply going to opt into this model. What is most exciting for us is this is a model where we kind of have more influence. We can really demonstrate techniques, platforms, capabilities to the rest of our 88 partner firms. And that has a very kind of very strategic potential that goes just beyond the numbers.

Unidentified Participant: Got it. Great. All right. Let's shift gears. Maybe spend a couple of minutes, we have a clock here, on some of the financial targets and some of the guidance items. I guess if we look at 2022, especially all things considered, it's been a pretty robust year for the firm. I think earnings per share are still on track to grow somewhere probably in the teens just based on kind of the guidance that you provided for the fourth quarter. If market conditions remain fairly challenging, not saying equity markets go down like 20%, but kind of range balance somewhat volatile, how are you thinking about the ability to sustain this type of EPS growth into 2023?

James Shanahan: Yes. Well, I think the first thing is regardless of markets, what you see is stability of cash flow, stability of earnings in our model kind of across all cycles. So it's certainly a well-designed model. And what a lot of investors are starting to do now is they're starting to delineate the components of our model and what kind of that drives the earnings. So obviously, we have just reported 23.9% of our revenues are not correlated to the market. So you have about $500 million of the business that regardless of market conditions are still growing nicely here, and this is outsourced CFO services. We charge hourly, fixed retainers and so forth. So they look at that first slice, if you will, of our financial models, which generates the earnings and the EPS. Then the second thing that they look at, especially during times of market volatility, unless they're in bull markets is the slide we have every earnings call about preference.

So over the last several years, we generally buy between 40% to 60% of the cash flows. We have $155 million of cash flows. So this is sort of a nice comfort level during times of volatility. They continue to show the stability of our earnings for future years. And then the third piece that they sort of look at is, okay, there's many partner firms that have grown well beyond the preference that have been with us for many years. But even in that situation, we still monetize between 40% to 60% of the cash flow, and that's variable in nature. So you have stability there of the base model. You add-on all the mergers that Rudy mentioned, the new partners, stay within the leverage capacity, you're able to drive good earnings there.

Now the benefit of amending the credit facility was you take the refinance risk off the table and you create the dry powder, but that did come with a higher interest expense component. So that will be a bit of a headwind for us into '23. But we've been building this model for many years working with Rudy since 2006, and we're driving the long-term earnings growth double digits over time.

And as we become more successful and we have new firms join us, that cash flow kind of continues to grow over time. We redeploy it back into the business, which creates additional earning capacity. But we're staying within the leverage confinement. We have a large addressable market for many years to help grow that earnings growth.

Unidentified Participant: Got it. And I guess as a subcomponent to that, EBITDA margins have been a bigger focus for the firm as well. And with the benefits of your adding additional partners and some of the new kind of models that you rolled out, the benefits of scale should really start to kind of kick in. Does that take a back seat at all in the current market conditions and current market environment? Or as you look out into '23, you still think you'll be able to drive EBITDA margin expansion?

James Shanahan: Well, I think you kind of go back in history, if you look at '19 to '21, we were able to grow our margins by 3%, and we lived through COVID during 2020. Last year, '21, our margins are about 25% adjusted EBITDA margins. This year starting a lot of market volatility. About 3/4 of our revenue is market dependent, and we'll probably exit the year around 25% adjusted EBITDA margins as well. So certainly, a large part of the business has market correlated revenues, but we have all these unique features, the preference, the split in of the cash flow, as I mentioned. And we got the stability of the nonmarket correlated revenues during these times of volatility.

So in the short term, markets could impact the adjusted margins, but we look at the long-term growth and drive those margins with the value-add services and so forth. But certainly, if markets are depressed on a prolonged basis, we can adjust cost to enhance the margins. But at this point, we're really looking at the growth opportunity with our partners and driving the long-term results.

Ruediger Adolf: Clearly, margins never should be on the backseat. But the ability to sustain the growth short, medium, long term is, of course, the priority and our numbers speak for themselves.

Unidentified Participant: Yes. Let's zoom out a little bit. We started this conversation with your Investor Day and the targets you set out for 2025. So maybe it's a good place to go back and just got a quick health check on that as well. So you talked about $1.1 billion of adjusted EBITDA, almost 2x where you were -- almost 2x where you're tracking really for 2022. I guess with everything we talked about today and tougher market conditions, what's your ability to achieve these targets? Kind of how do you feel about them now?

Ruediger Adolf: Yes. Well, obviously, we brought them out in -- we announced them in Investor Day last year, which feels like 100 years ago, from an economic environment. Clearly, if the markets just freeze where we are, it would be impossible to make these goals. But reality is, Alex, for every 2020, there's a 2021. And for every difficult time, there's a recovery. And depending on whatever this momentum is, '21 was the best year probably in our history or certainly one of the very best years of our history. This thing can turn around very, very quickly. If there's a more steady recovery, that's fine, too, maybe it pushes out by a year or two. But when you put out this type of aspiration, it's a number, of course, it's a number, but I think much more important it's about the potential.

And it is about describing what we believe is just an unlimited market where we are the market leader globally. And maybe it's a year or two later, but reality is we are there. We are showing enormous resiliency in good times, and we have this terrific ability to recover when things change. So I'm not sure what the right year is right now, but we're going to get there, and I feel very, very good about this strategic trajectory that we own.

Unidentified Participant: Great. Fair enough. The last question that I have and if we have time, we can turn it over to the audience. But I did want to touch on share repurchases. Stocks valuation is clearly not expensive relative to the growth you've been delivering, but you've been very limited in terms of share buybacks. What gets you to be ultimately more aggressive here?

Ruediger Adolf: Yes. So we were very careful when we announced our authorization. It's not a strategic repurchase program. Given all the opportunities we discussed, given the terrific momentum on the M&A side. That's the best way for us to continue deploying capital. But we basically got the authorization that in case there is some other disruption that is way beyond of what we are seeing so far. We have the capacity to step in. We will step in. Jim and I know exactly what the kind of the right entry point would be. We are clearly not at this entry point at all.

But ultimately, we work for our shareholders. When the right prudent allocation of capital is to buy back our stock, we are ready. We can do that. But most certainly, given the strategic discussion that we had here, we are not at this point and quite frankly, the opportunity is just unlimited and this is how we are running the business. And this is what we are positioned for.

Unidentified Participant: Okay. All right. Fair enough. One or two minutes on the clock. So if there are questions, we could take maybe one from the group. One up here please.

Unidentified Audience Member: You described a really nice capital allocation potential. Do you feel like you're a little constrained on the resources you have today? Would you want to deploy even more capital than you can even though you're kind of governing yourself? I'm just trying to get a sense of--

Ruediger Adolf: Yes. You definitely -- it's a very good question. And the opportunity -- Focus is not opportunity constraint. It is ultimately, we are growing the business prudently in the scale that we have. Could we double the deployment in capital? Yes, we probably could. And it would have only a marginal impact on returns. Of course, we manage the business in all of its facets. I think we are deploying capital as is appropriate.

But now we are not opportunity constrained. We, both in the U.S. and in international markets, there are opportunities way beyond of what we are doing today. But it's also quite frankly, it's a good thing in so many ways because it's a discipline. Our job as capital allocators is to put the capital to its best opportunities. So we are cutting off many deals that, quite frankly, could be attractive. But ultimately, we go to where the opportunity is and that creates a certain discipline in the business model that we have demonstrated for years now.

Unidentified Participant: Great. All right. Well, we're perfectly at time. So thank you, everybody, for joining. Rudy, Jim, thank you so much for being here. Always a pleasure. Thanks.