Focus Financial Partners Q1 2021 Earnings call
May 5, 2022

<u>Presenters</u>
Rusty McGranahan - General Counsel
Rudy Adolf - Founder and CEO
Jim Shanahan - CFO

<u>Q&A Participants</u>
Craig Siegenthaler, Bank of America
Marc Palucci, Oppenheimer
Ryan Bailey, Goldman Sachs
Matt Moon, KBW
Michael Young, Truist Securities

Operator
Good morning. I would like to welcome you--welcome everyone to the Focus Financial Partners 2022 First Quarter Earnings Call. Joining today's call are Rudy Adolf, Founder and CEO; Jim Shanahan, Chief Financial Officer; Rusty McGranahan, General Counsel; and Tina Madden, Head of Investor Relations and Corporate Communication.

At this time, all participants are in a listen-only mode. A question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star and then zero on your telephone keypad. As a reminder, this conference is being recorded.

Mr. McGranahan, please go ahead.

Rusty McGranahan
Good morning, everyone. Before we begin, let me remind you that during the course of this call we may make a number of forward-looking statements. We call your attention to the fact that Focus's results may, of course, differ from these statements. These statements are based on assumptions made by and information currently available to Focus Financial Partners, and involve risks and uncertainties that could cause the results of Focus to materially differ from these statements.

Focus has made filings with the SEC which list some of the factors that may cause its results to differ materially from these statements. And finally, Focus assumes no duty and does not undertake to update any such forward-looking statements.

With that, I will turn it over to our founder and CEO, Rudy Adolf. Rudy?

Rudy Adolf
Thanks, Rusty. Good morning, everyone, and welcome to our call today. We appreciate your interest in Focus. Before getting into the details of the call, I want to take a moment to reflect on the geopolitical events that have unfolded in recent weeks. As a native European, this unimaginable tragedy hits particularly close to home. We must all acknowledge the bravery, sacrifice, and spirit of the citizens of Ukraine in the face of such inhumane and unprovoked aggression.

This morning we announced excellent Q1 results, again reflecting the stability of our business, the diversity of our revenue mix, and the resiliency of our adjusted EBITDA margin during challenging market conditions. We grew revenues 36.1 percent year-over-year to $536.6 million, and our organic revenue growth rate was 22 percent for the same period. Our adjusted net income, excluding tax adjustments per share, was $0.98, and tax adjustments per share was $0.18, increasing by 22.5 and 38.5 percent respectively. Our performance again exceeded our expectations on all measures and reinforced our continued disciplined execution.

The quality of our partnership also was evident in these results, as our partner firms remained agile in helping their clients navigate the complex macro backdrop. It is critical to remember that they primarily serve a sophisticated high and ultra high net worth clientele that seeks to achieve capital preservation across market cycles. Volatile market conditions are when prudent fiduciary advice is of utmost importance, reinforcing the loyalty of these relationships.

Although we believe that market and geopolitical uncertainties will persist well into 2022, the strength of our first quarter performance is significant because it enables us to reaffirm our 20 percent plus revenue and adjusted EBITDA growth targets for 2022 and the progress towards our 2025 objectives. I would challenge listeners to find companies with comparable targets in the financial services industry. These targets reflect substantial upside and future value creation for our shareholders.

Year-to-date, we have continued to invest in leading wealth management firms that complement our partnership by further strengthening our presence in strategically important wealth markets. The addition of Azimuth, which closed on April 1st as our newest partner firm, is a good example. Azimuth, which manages approximately $3.5 billion in client assets, is a prominent independent wealth management firm in Michigan and an industry leader. Azimuth is known for its well established business, the distinctiveness of its investment management capabilities, and the continuity of its dynamic management team.

We have also closed four mergers year-to-date and signed one additional merger, which we expect will close late in the second quarter. Two of these transactions are for partner firms completing their first mergers, ARS Wealth Advisors and InterOcean, who joined us in 2021 and 2020 respectively, and one for Connectus. Additionally, Buckingham and The Colony Group have both completed their first mergers of the year. These transactions reinforce our expertise

in helping our partners expand their businesses and add additional talent by sourcing attractive merger opportunities.

We recently announced the signing of Octogone Group, which will be our 86th partner firm and our first in Switzerland. This represents an important evolution in our international growth strategy, which is to expand our partnership in countries with large independent wealth management sectors that cater to high and ultra high net worth clients and are experiencing cyclical dynamics similar to the U.S., regulatory changes, or other discontinuities. Australia, Canada, and the UK are examples of this.

We have always envisioned that Focus would be a global business, and our decentralized structure is flexible enough to support partner firms in many different countries. With just 5.5 percent of our revenues coming from partner firms' operations outside the U.S., we believe that our international expansion will be a meaningful growth opportunity.

Switzerland is a good example of a market with the characteristics that are very attractive to us. According to the 2020 annual report of the Swiss Association of Wealth Managers, the independent market in Switzerland is approximately half a trillion dollars in client assets with demographic trends that are similar to the U.S. Additionally, the Swiss financial market supervisory authority is implementing new licensing requirements for independent wealth managers which will be a catalyst for consolidation. We have a significant first mover advantage in this market, which we believe will give us access to high quality firms with truly global high and ultra high net worth clientele.

Octogone is one of the largest and most elite wealth management firms in Switzerland, with approximately $5 billion in client assets and significant expertise in the ultra high net worth market globally. Founded nearly three decades ago, Octogone provides comprehensive wealth management solutions to wealthy individuals and families in Europe, the U.S., Latin America, and the Middle East. Its team includes over 70 wealth specialists spanning 18 nationalities and 10 languages, reflecting its global orientation.

Reflective of its reputation, Octogone has a substantial and global pipeline of new business. This is an important strategic acquisition for Focus, positioning us to enter additional markets in Europe and other international geographies while further diversifying our partnerships and expanding our footprint in the ultra high net worth market.

Looking forward, our pipeline is robust and our momentum remains strong, positioning us for another successful M&A year. Our business model continues to resonate, with significant interest across our three acquisition structures. As we foresaw last year, and contrary to many pundits, M&A momentum has continued to build in 2022. According to DeVoe's latest update, Q1 set a new high watermark for industry M&A activity and was the second strongest quarter ever, with any later quarter slowdown likely temporary in nature.

The advantages of scale, the aging of a generation of founders, and importantly, the increasing client demand for highly personalized, unconflicted advice are trends driving a strategic long-term consolidation of this industry. As 2020 made clear, navigating successfully in this environment is not just about staying the course but also about positioning ourselves to take advantage of the opportunities that will arise post the current geopolitical crisis.

To again highlight the Cerulli data, RIAs in the U.S. have historically increased their client asset growth substantially in the first two years after a market disruption relative to their long-term average growth rates, creating an exceptional margin of outperformance. The driver of this growth has been RIA industry performance and the value of holistic client service during all market cycles, including downturns.

As we predicted in Q2 of 2020, we saw this dynamic play out in 2021. We were substantial beneficiaries of that, delivering our strongest year yet, which demonstrated meaningful upside to our shareholders. We believe that this same market growth dynamic will repeat itself when we emerge from the current geopolitical crisis.

The strength of our Q1 financial performance also enables us to continuing deepening our value-added capabilities. Surrounding our partners and their clients with a robust suite of services in areas such as alternative investments, credit trust and estate planning, and insurance, to name a few, is especially important in this environment. Not only are these resources central to our value proposition, but they also further reinforce the attractiveness of our partnership.

As we turn our sights to the second quarter and the remainder of this year, I firmly believe that investors will soon again appreciate the enormous resiliency and stability of our business model. They will also come to appreciate the size of our addressable market, both in the U.S. and internationally, and our differentiated value proposition within those markets. They will see the power of our programmatic and global approach to M&A, as well as our continued discipline in being good stewards of our capital.

We have successfully navigated market dislocations through our 16 years of history, and the learnings from those experiences are embedded in our business model. Our performance in 2020 was a great example of that. Rajini, Lenny, and I are confident that 2022 will be another excellent year for our business and that we will continue to be the beneficiaries of substantial industry growth and consolidation. I quoted Andy Grove in 2020, and I think his quote is equally relevant today. Bad companies are destroyed by crises. Good companies survive them. Great companies are improved by them.

One final note before turning the call over to Jim. We recently issued our third sustainability highlights report and made further enhancements to our ESG initiatives, including the purchase of carbon credits to neutralize the impact of business air travel by Focus employees. The details can be found on our website and in our recently filed proxy statement. We remain committed

to taking ESG considerations into account for all aspects of our business. We are also encouraging and supporting our partner firms in their development of ESG investing and other strategies to support the increasing ESG interest of their clients.

With that, let me turn the call over to Jim. Jim?

Jim Shanahan
Good morning, everyone. We delivered excellent results this quarter, once again demonstrating the stability and resiliency of our business against a choppy macro backdrop. While the dynamics driving the current environment are different than what we experienced in 2020, our partner firms are equally well equipped to weather this storm and are performing very well.

Our business is stronger and more diverse, with a substantially larger footprint globally than where we were just 24 months ago. From Q1 '20 to Q1 '22, we have increased our partnership by 20 firms and added Connectus. Over the same period, our revenues grew 59.2 percent and our adjusted EBITDA by 73.1 percent. I have no doubt that we will successfully navigate the current challenges and our business will emerge even stronger and better positioned for growth.

Now turning to the key elements of our P&L, our Q1 revenues were $536.6 million, increasing 36.1 percent year-over-year and $16.6 million above the high end of our guidance range for $510 to $520 million. Our revenue outperformance was driven by an increase in our nonmarket correlated revenues associated with our family office services and a small amount of performance fees, of which approximately $3 million was one-time and will not recur in Q2. Our Q1 year-over-year organic revenue growth rate was 22 percent, also above the high-end of our 16 to 19 percent guidance, primarily due to the factors I just mentioned.

I want to take a moment to highlight several elements of our revenue model which drive the resiliency of our revenues during periods of market stress. First, 95 plus percent of our revenues in Q1 were recurring and are primarily fee-based rather than being based on commission or other transaction fees. I can't emphasize strongly enough how important the recurring nature of our revenue is to the stability and predictability of our revenues and profits.

Second, 21.8 percent of our revenues in Q1 came from sources not correlated to the markets. Unlike 2020, when these revenues were impacted by the effects of COVID on live events, they are and will continue to provide an important source of diversification as we navigate this period.

Third, 5.5 percent of our Q1 revenues came from international sources, which provides another important source of global revenue diversification. As Rudy discussed, our international expansion is an important strategic priority.

And fourth, approximately 66 percent of our Q1 market correlated revenues were billed in advance, while 34 percent were billed in arrears. This structure is also an important source of diversification because it reduces the impact of volatile markets on our revenues in any given quarter, generally resulting in a one quarter lag effect on any market movements on our revenues.

The combination of these four revenue elements, plus the variable nature of our management fees and earnings preference, enabled us to navigate the volatility of 2020 and positioned us for the record year we had in 2021. They are also why we have been able to deliver so successfully against the tight quarterly guidance we have provided every quarter since Q1 2020.

Our Q1 adjusted EBITDA was $135.1 million, reflecting year-over-year growth of 33.7 percent, and our adjusted EBITDA margin was 25.2 percent, in line with our guidance of approximately 25 percent. As we anticipated and noted last quarter, our Q1 M&A closings were lower given the 22 transactions we completed in Q4 of last year. We closed one merger during Q1, and on April 1st we closed on Azimuth Capital Management, our 85th partner firm. We estimate Azimuth will contribute approximately $4.5 million in revenues and $2.8 million in adjusted EBITDA in Q2.

Additionally, we anticipate that Octogone will close in Q3, subject to regulatory approval, and will contribute estimated annual recurring revenues and adjusted EBITDA of more than $20 million and $5 million respectively. This firm will further enhance the diversification of our revenues and cash flows.

As Rudy highlighted, our 2022 pipeline is strong, with a high quality transaction mix. Joining an international partnership of 85 firms, led by dynamic management teams and catering to high and ultra high net worth clients, which are generally the stickiest relationships in the industry, is unique in the independent wealth management space.

Now turning to our Q1 expenses and cash flow, management fees were $137.8 million, or 25.7 percent of revenues, which was a slightly lower percentage sequentially. This percentage is reflective of the contractual economic relationships we have with our partner firms. Non-cash equity compensation expense was approximately 1.2 percent of revenues, in line with our estimate, and we expect expense will be approximately 1.4 percent of estimated Q2 revenues.

The first quarter of 2022 was impacted by $9 million of non-cash earnings, reflecting changes in the fair value of estimated earn-outs pursuant to our Monte Carlo simulations under GAAP. Market conditions drove a reduction in the estimate of these long-term liabilities as of March 31st. As markets recover, these estimates typically increase.

As of March 31st, our LTM cash flow available for capital allocation was $299.6 million, increasing 36.2 percent year-over-year, further amplifying the sustained growth and financial

performance of our partnership. The increase also reflected the effect of our typical Q1 release of our management fee hold-back in connection with our annual audit.

Our gross unamortized tax shield was in excess $2.5 billion as of March 31st, and will support our cash flows in future periods. We also paid cash earn-out obligations of $34.2 million, which was in line with our Q1 estimate, and we estimate that our earn-outs will be approximately $35 million in Q2.

Now let me review our Q2 P&L expectations. We estimate that our Q2 revenues will be in the range of $525 million to $535 million, and that our organic revenue growth rate will be 11 to 14 percent. Our revenue guidance reflects the recent market volatility and our Q2 acquisition activities. Included in our Q2 outlook is approximately $4.5 million in revenue from Azimuth, as well as approximately $3 million in one-time revenues from Q1 which will not recur in Q2.

Additionally, our Q2 weighted average adjusted shares outstanding will increase by approximately 512,000 shares associated with Q2 acquisitions to date.

We anticipate that our Q2 adjusted EBITDA margin will be between 24.5 percent and 25 percent, which would bring our first half 2022 margin to approximately 25 percent. While our margin can vary quarter to quarter, we evaluate our business based on annual performance.

Importantly, I'd like to reiterate that we are reaffirming our annual growth guidance for this year of 20 plus percent growth in revenues and adjusted EBITDA. The strength of our Q1 results, together with the resiliency of our revenue mix and stability of our business, position us to reaffirm these target despite challenging market conditions.

Now let me turn to our balance sheet. As of March 31st, we had approximately $2.5 billion in debt outstanding, and we ended the quarter with a net leverage ratio of 3.84 times, which was within our estimated range of 3.75 to 4 times. We estimate that our Q2 net leverage ratio will be in the same range.

I know that a number of you have asked about the trajectory of our interest expense this year given the backdrop of rising interest rates. As a reminder, $850 million of our $2.5 billion of debt outstanding has LIBOR swapped from a floating rate to a fixed weighted average interest rate of 62 basis points plus a spread of 200 basis points. The remaining $1.6 billion is floating rate, which has a few pieces. The larger elements include a $794.4 million Tranche B term loan, which has a 50 basis point LIBOR floor plus a spread of 250 basis points, and a $756.7 million Tranche A term loan, which is LIBOR plus 200 basis points with no LIBOR floor.

We typically use 30 day LIBOR in our term loans. Assuming 30 day LIBOR was 200 basis points higher in Q1 than the average LIBOR rate of 14 basis points in effect during the quarter on our term loan borrowings, we would have an incremental quarterly pro forma pre-tax interest expense of approximately $7 million. This type of pro forma increase does not inhibit our ability

to achieve our growth targets this year. We have included sensitivity analysis on page 19 of our earning supplement to show you the pre-tax effect on our Q1 interest expense of various increases in 30 day LIBOR.

I also wanted to comment briefly on our recent extension on the term of our revolver. We extended a maturity date to June 2024, which further reduces our duration risk. Concurrent with the extension, we'll use SOFR as a revolver replacement benchmark interest rate for LIBOR, but we don't anticipate this change will have any material effect on our revolver interest expense in future periods.

In closing, our strong Q1 financial results enable us to reaffirm our 20 plus percent for revenues and adjusted EBITDA growth targets for this year. The benefits of the diversification of our revenues were once again evident in our financial results during a very challenging period in the markets. Our partners' businesses are built on deep, long-standing client relationships that have stood the test of time across many cycles. Similar to 2020, we have--we fully expect that the resiliency and stability of our results will continue to be evident as we navigate the current market and geopolitical turbulence.

We and our partner firms are also actively planning for post the current crisis period, which we believe will offer substantial growth opportunities as it has after other major crises, as was most recently evident in our 2021 results. As one of our partner firms said in 2020, which is fitting for today's environment as well, it's not about weathering the storm, it's about coming out strong on the other side.

Let me turn the call over to the operator for Q&A now. Operator?

Operator
Thank you. At this time, we will be conducting a question and answer session. If you would like to ask a question, please press star and then one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star and then two if you would like to remove your question from the queue.

For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment, please, while we poll for questions.

Our first question is from Craig Siegenthaler of Bank of America. Please go ahead.

Craig Siegenthaler
Good morning, Rudy, Jim. Hope you're both doing well, and congrats on your first Swiss transaction.

Rudy Adolf
Thank you, Craig, very exciting.

Craig Siegenthaler
So, my first one is on the competitive landscape for U.S. RIA M&A. Given the sharp correction in equity and bond prices year-to-date combined with higher rates, are you seeing any change in the competitive landscape? And what I'm really looking for is have you seen any of your competitors pull back, which could benefit future target multiples in your future transactions?

Rudy Adolf
Yeah. So, as you know, Craig, we have never been overly kind of worried about competitive pressures because we have a very unique value proposition, yeah? You want to be an entrepreneur, you want to have value-added services, and you want access to permanent capital, Focus in the only game in town. And we have never seen big kind of multiple inflation, yeah, in the way we deploy capital. And we have proven that in Investor Day, where, you know, we showed that actually our returns over time for capital deployed have actually improved.

So, we, yeah, certainly avoided so many of the--yeah, I think I called them drunken sailor transactions that we have seen last year. And yes, what we are seeing is that, some of these heavily overpriced transactions, the buyers are suffering now. And, yeah, quite frankly we do see--when I look at our pipeline, we see stable, maybe even slightly improving, yeah, multiples in the way we are deploying our capital.

So, we have a very strong pipeline. I can state with confidence that 2022 will be one of our most successful M&A years again, yeah, probably not quite on the level as last year, but we will have a--one of--a very, very successful year. And, yeah, multiples are stable, if not improving. And yes, some of these, yeah, highly over-levered, yeah, P/E type models and foreign buyers and others, from what we can tell, are suffering from, yeah, some of the deals that they did last year.

Craig Siegenthaler
Thanks, Rudy. And just for my follow up, it was nice to see a deal in a new market, Switzerland. So, you know, now you guys are obviously very big in the U.S. You have Canada, Australia, UK, Switzerland, kind of five very large markets. What markets could be next?

Rudy Adolf
Well, you know, we just announced our first deal in Switzerland, and we still have to close it. But quite frankly, I couldn't be more excited about this market. I--yeah, we have been watching the market, traveling in and out for years there. And with Octogone, we really managed to attract one of the top players, yeah, in the Swiss market. It's a half a trillion dollar market following many of similar dynamics. So, we--yeah, quite frankly, also the response when we announced this transaction, I spent time with the team actually yesterday, could not have been stronger. And, yeah, it's boding well for the future in this market.

Additional markets, you know, I've nothing to announce yet. But we are constantly looking at, yeah, where are the most attractive locations to--yeah, in the wealth management industry. We have our tentacles into, yeah, a number of markets. Rule number one for us is continue growing in the U.S.; two, continue expanding in the markets that we already have the presence; three, now we added Switzerland. And yes, here there are other markets on the drawing board that, if and when, yeah, we are ready, we will add to our, yeah, TAM here.

Most importantly, and I think a distinctive competitive advantage is, yeah, that we are ultimately, of course, deploying capital by partnering with these entrepreneurial well managed firms, and we can deploy capital into, yeah, wherever we've--we see the best opportunities. And this gives us a very unique ability to diversify the deployment in capital. And, yeah, we have obviously a very strong track record of doing this since 2006.

Craig Siegenthaler
Thank you, Rudy.

Operator
Our next question is from Owen Lau of Oppenheimer. Please go ahead.

Marc Palucci
Thank you for taking my question. It's Marc Palucci on for Owen. Just wanted to ask, you know, you reaffirmed your 2022-2025 target for 20 percent revenue and EBITDA growth. Given the weakness in equity markets and volatility, it looks like M&A has slowed down recently. What kind of makes you feel confident you can reaffirm this guidance? Thank you.

Rudy Adolf
Well, of course, Jim and I don't do this easily when we reinform--reaffirm guidance, and the excellent Q1 results really gave us a terrific foundation to do that. Q1 was a little slower on the M&A side, but it usually is. But quite frankly, we closed, Jim, what was it, 22 transactions in the first quarter last year, and, yeah, just came out of a year where we did 38 deals. So, we needed to take a little bit of a breather in the first quarter.

But as I said before, pipeline is very strong. You will see one announcement after the other of very attractive transactions, and transactions that both are strategically of high value and, of course, financially within the framework that we are deploying capital. So, what you see and what we are demonstrating again is simply the resiliency of our business model.

Yeah, if anything, in 2020, and some of you remember the second quarter of 2020 when the full impact of the COVID market correction really impacted the business, yeah, we really demonstrated how well we weathered this storm, how quickly we recovered out of the storm, and ultimately had the momentum out of 2020 that turned into 2021 being the most successful year, yeah, in--certainly since we've been public.

So, we are very confident, revenue 20 percent plus growth, EBITDA 20 percent plus growth. I don't think that there are many businesses in financial services that, yeah, can provide this guidance, but even more important, yeah, see this in the context of our long-term--of Focus 2025. And, yeah, we are trekking towards, yeah, our 2025 goals. We believe that they are ambitious but achievable, and, yeah, to remind you, $4 billion in revenues, $1.1 billion in EBITDA, and an adjusted margin of 28 percent. So, yes, confidence in 2022, but also confidence as we are trekking towards '25.

Jim Shanahan
Yeah. I think maybe the only thing I'd add is obviously, in our industry, we have the largest M&A team. Our partner firms are an extension of that. And as you know, we go to the market with three acquisition models adding new partners. We have Connectus that we launched about a year or plus ago, and we do mergers for our firms. So, we have over 85 firms now that are platforms for accretive mergers. So, that kind of gives us the confidence and visibility into the pipeline to set these 20 plus percent goals for 2022, even during times of market volatility.

Marc Palucci
Great. Thanks for the color. And then one more is, you know, I appreciate the color you provided on slide 19 around interest rate sensitivity. Maybe if you could just talk about some of the levers you can pull with a recession looming on the horizon, how you're thinking about capital allocation. I know, you know, your management team has been through this situation in the past and Focus has remained resilient. But maybe some of--you know, if you can call out maybe some of the shields that you have, or anything that you have to kind of weather the storm.

Rudy Adolf
Yeah. And Jim can go through some of these kind of structure shields of defense that we have in our business model. But more important--and, yeah, certainly I don't want to sound callous here. These are very tough times out there in just many aspects of the economy, and certainly geopolitically. But our business is made for times like this. You know, there is no other time when prudent fiduciary advice, yeah, holistic, yeah, delivered by advisors who are not, like a broker, selling things, but really providing, yeah, holistic advice to clients, yeah, usually, of course, that they know for many, many years. This is where this advice matters the most.

And just looking back to 2020 again, yeah, we were very resilient during 2020, are still growing, yeah, almost 20 percent, yeah, on an EBITDA basis in 2020, but it was this client retention, it was, yeah, quite frankly, new client referrals, some consolidation of assets from clients that then led to this tremendous performance in 2021. And yeah, quite frankly, yes, volatility, complexity, tax changes, geopolitical uncertainty, this is when best advice is absolutely critical.

Jim, do you want to go through those financial shields?

Jim Shanahan

Yeah. I would just say, I mean, some of them I noted in the prepared remarks. But, you know, we're a business with 95 plus percent fee-based recurring revenue. Our management fees, which are our second largest operating expense, are variable in nature. 21.8 percent of our revenues in Q1 aren't correlated to the market at all. Obviously, we're adding new partner firms internationally, so that gives a further diversification of our revenue.

Our P&Ls are run by entrepreneurs who know how to manage their cost structure during volatile times. This was clearly evident in 2020 on the onset of COVID. And we certainly have some volatility now, and they'll run the P&Ls accordingly to support the margin of the business. And, you know, we continue to generate great cash flow. Our LTM cash flow for capital allocation continues to grow. And we redeploy that into the business or, you know, if there are extreme periods of volatility, you know, then we would use that excess cash to pay down debt vis-à-vis doing an acquisition.

Marc, does that answer your question?

Marc Palucci
Yep, all set. Thanks, guys.

Jim Shanahan
Thanks.

Operator
Our next question is from Alex Blostein of Goldman Sachs. Please go ahead.

Ryan Bailey
Good morning, Rudy and Jim. This is actually Ryan on behalf of Alex.

Rudy Adolf
Hi, Ryan.

Ryan Bailey
Hi. How's it going? So, I had a question on merger activity, which looks like it continues to be solid in 2Q. And I was wondering if you can speak to what your partner firms are thinking about mergers, just given the volatile market backdrop. And then also, for the merger target firms, what are you hearing from them in your conversations?

Rudy Adolf
Yeah. So, mergers in so many ways, Ryan, was really an innovation. It's, if you want, an industrial scale that we brought to this industry. We have done probably 150 or so of mergers over the years and have just build tremendous expertise. You may remember last year we did 38 transactions, 24 of which are mergers, which includes, of course, the Connectus

transactions. Year-to-date, we have either closed or announced already five merger transactions.

So, this is a terrific way for our partner firms to grow. It's a terrific way for, quite frankly, a small or a medium sized firm to team up with teams with similar cultures and similar clients and, you know, similar prospects, yeah, and ultimately accomplish what is critical in this industry, and that is scale. So much of what is driving mergers in general is, yeah, first, clients need more and more sophisticated services. And for smaller firms, it is very difficult to deliver these services.

Two, yeah, when you're at a larger scale, yeah, quite frankly, you can grow better. You know, growth is easier because so many firms that are kind of small or medium sized in this industry have this classic entrepreneur's dilemma where, yeah, they have to do everything. And of course, most importantly, they have to advise their clients. They have very little support around them, and as such, yeah, quite frankly, can't grow because they don't have enough time to develop new business.

Typically, mergers are for four reasons; first, for--to support geographic expansion; second, to provide new services to a firm; three, very important, and particularly important in this day and age right now, is to add next generation talent to a partner firm; and then, yes, of course there are expense synergies here that can be very, very helpful. So, very important part of our business model, a critical reason why partners join us, and we have a terrific merger pipeline.

Ryan Bailey
Got it. Okay. And maybe just one question from the outlook for the 2Q. I was just wondering if you could comment on your thoughts around the use of equity for deals, just given what's happened with the stock price year-to-date and how you're thinking about that. I think the implication from the 512,000 shares is something like 23 million-ish roughly. But I guess I was just wondering how you're thinking about it more philosophically.

Rudy Adolf
Yeah. So, most of the deals that we do are all cash, and that will continue to be the case. Yeah, cash is still very cheap and a very attractive currency to deploy. But we use stock, and, yes, we use it from time to time, first and foremost for strategic reasons, yeah, when we feel that--quite frankly, sometimes there are tax reasons as well. But, you know, there is an interest need for this kind of deeper level of alignment. And there, quite frankly, stock is a very attractive and, as I said, you know, a very tax efficient currency for us to use.

So, of course, we are factoring into the economics here when we look at the, yeah, accretion of a transaction. You know, the use of stock, it's just part of the formula that we are using. Of course, it's a very small percentage when we look at the 84.6 million shares outstanding that we currently have. But it's just part of the economic equation. And yes, when we see the right opportunity, strategic tax-wise, then we will continue to use stock on an exception basis.

Ryan Bailey
Got it. Thank you.

Operator
Our next question is from Kyle Voight of KBW. Please go ahead.

Matt Moon
This is actually Matt Moon on for Kyle. Just one on capital management for me. Just given the stock performance year-to-date, and with you guys sitting towards the lower half of your target leverage range, I'm just kind of wondering if--how you're thinking about your use of capital from here, maybe specifically thinking about if you would ever consider a buyback or a repurchase program as an alternative use of capital versus M&A or debt paydown.

Rudy Adolf
Well, first and foremost, we manage the business, not the stock. The business is not the stock and the stock is not the business, certainly, in short-term volatility. And ultimately, we are committed towards this journey, this 2025 journey, that we have laid out on Investor Day. We--when we deploy capital, and we showed this in Investor Day, 90 percent of the transactions that we are doing create IRRs north of 20 percent. So, we see a tremendous opportunity.

Buybacks I think is a very short-term opportunistic thing. Of course, we will look--we are looking at this math here. Quite frankly, it would not be attractive right now given the terrific returns that we are generating when we deploy capital and, quite frankly, the strong pipeline and really the business that we want to build. So, it's a factor, but now we have tremendous opportunities, and we will continue to manage the business with the discipline that we have demonstrated. And quite frankly, when--yeah, ultimately, there will be an alignment between the excellent business performance and share price. And you've just got to be patient, yeah, along the way here.

Matt Moon
Okay. And then just another one for me just going back to Octagon. I think just given that you've sized the market, is it fair to think that you--that that might mean that you guys will be more aggressive in the near term in targeting and pushing into this country specifically? And I guess for those of us who are maybe not as familiar with the characteristics of that market in the financial advice space, could you maybe just go through the characteristics of what makes this region an attractive opportunity, and maybe compare that to the secular trends you're seeing in the U.S., since we're more familiar with those trends?

Rudy Adolf
Yeah. Yeah. So, we--yeah, we, and quite frankly, I personally know the Swiss market, yeah, very well. For a very long time in my career, I was in and out the market. And ultimately, if you want to be in the wealth management industry globally, you need to have a footprint in the Swiss market. It has, yeah, almost centuries of expertise built up of client relationships of just very,

very high-quality businesses. And quite frankly, to Switzerland's credit, yeah, after all, yeah, of these kind of tax issues that they had to deal with, they really cleaned up the market and turned it into a high-quality wealth management hub that we believe will have just tremendous opportunities going forward.

You know, I stated on other earnings calls or on Investor Days, yes, we have a strategic objective to internationalize the business more. We like the diversity we are getting. We like the--quite frankly, the returns on capital that we are expecting in these markets. We like that we have first mover advantage in any of these new markets in a tremendous way. And quite frankly, starting with a partner like Octogone, we are starting with an absolute winner, yeah, that has tremendous potential.

And so, yes, we expect more announcements, of course, in this market. But it's--you know, it's not some aggressive push because, quite frankly, we have opportunities everywhere. We--as I said, we have a very strong pipeline. And yes, for the right opportunities, we are very eager to deploy capital in a number of these international markets. But, you know, it has to be the right opportunity with the right kind of long-term strategic potential, yeah, that we see in these transactions. But stay tuned. There will be more

Matt Moon
Okay, great. Thanks, guys.

Operator
Our next question is from Michael Young of Truist Securities.

Michael Young
Hey, good morning. Wanted to follow up kind of on the international M&A question. Just, you know, given the volatility of both equity markets and the disruption from kind of the Russia issue in Europe, has that caused any delay of deals that maybe would have come through otherwise? And should we expect that there might be some like pent-up demand at all?

Rudy Adolf
Well, of course, when you're in Europe, you're feeling the impact, yeah, just so much closer, you know, particularly of the war than when you're here in the States. And reality is, yeah, impact number one is, yeah, quite frankly, it's nobody is doing business with Russian clients, and we need to make sure that there are no Russian clients, yeah, in any of these targets that we are looking at. That's a very kind of tangible impact.

But otherwise, the fundamental dynamics in these markets are very similar to the U.S., yeah? You've got a large half a trillion market in this case. It's a market that has somewhere--2,000, 2,500 players. FINMA, so their regulatory authority, created a very--kind of a rigorous new regulatory regime that, quite frankly, many smaller firms will simply not be able to adjust to, yeah? This is one of these traditional drivers of consolidation that we see in so many of the

markets that we are operating in. And you have a very good universe of true high-quality firms, Octogone being one of them, that can really turn into platforms for mergers, yeah, that ultimately that we are envisioning.

So, yes, you need to be very cognizant, of course, what's going on in the world out there. And--but at the same time, we are so unique in the business model that we are offering in this market, yeah, just under any realistic assumptions here, we will have a terrific pipeline, yeah, ahead of us in a number of these markets.

Michael Young
Okay, great. And maybe one for Jim. Just on the EBITDA margin guide for 2Q and maybe just thinking more broadly, you know, was just curious kind of the assumptions that are going into that 2Q EBITDA guide in terms of market performance.

And then separately, just--you know, you mentioned, obviously, that the entrepreneurial firms can cut costs, you know, as markets sort of perform worse. But to what extent can they--you know, if we had a bigger dislocation, you know, is there some point at which, you know, they'd--you know, these aren't heavy cost structure businesses. So, you know, how much can they really cut costs? And when would you actually start to feel an EBITDA margin squeeze?

Jim Shanahan
Yeah, I think, you know, 2020 was a test of that. We had extreme volatility. And I think if you go and you look at the quarterly results in 2020, we had margin stability. I often say that the management fees reset with the profitability. It's a very unique feature of our model, and it's a really nice feature of the model to have during volatile times. So, our partners know how to manage the business and maintain the margin.

Obviously, as I commented earlier, we--we're fortunate to have a fee-based recurring revenue model, right? That's just critical. We have a slide in our earnings supplement that talks about the earnings preference as it's grown over time, which helps support the resiliency of that margin. Obviously, you know, we're very proud of our 25.2 percent in Q1, which was in line with the guidance. And, you know, we've provided the margin on our Q2 acquisition of the new partner firm. Connectus over time will support and enhance the margin.

And probably for the first half of this year, we'd be plus or minus 25 percent, and that reflects a lot of the market volatility because, as you know, the majority of our market correlated revenues are billed in advance, so that visibility has built in--been built into the Q2 guidance that we've provided of $525 million to $535 million of revenue.

Rudy Adolf
Yeah, and maybe just adding a little more from the business perspective, yeah, when we are out there talking to partners, yeah, when we are also talking to prospects, they are very optimistic about the trajectory of the business. They certainly do not see a need to adjust

expenses at this point, yeah? I think you see it with our 2020 guidance, yeah, that we also remain very, very optimistic. And it speaks to the resiliency and the power of this business model that, yeah, we will continue to trek towards ultimately 2025 objectives.

Michael Young
Okay, great. Thanks.

Jim Shanahan
Thank you.

Operator
We have a follow-up question from the line of Alex Blostein of Goldman Sachs.

Ryan Bailey
Hi, Ryan again here. I just wanted to quickly tie together a few comments and make sure I was thinking about this right in terms of the--sort of the pace of acquisitions and mergers over the course of the year. So, I think you said 2022 would be, once again, one of the most successful years you've had, positive comments on the pipeline. We have sort of the dotter of deals year-to-date. And so, I'm just wondering, should we expect the pace of deals to look similar to last year in terms of--you know, 4Q was a very, very strong quarter, which built on 3Q, which was better than 2Q, which was better than 1Q. Is that sort of the same sort of path that you're seeing for this year?

Rudy Adolf
Yeah. You know, Ryan, it's kind of impossible to precisely time M&A transactions. That's just beyond certainly our skills. But I very much stand to what I said before is, looking at the pipeline, looking at, yeah, where we are, this will be one of our most successful M&A years. I can say that Q2, Q3, we are going to see quite a number of attractive announcements.

But the actual timing of announcement and then even more so the actual timing of closing is very difficult, yeah? Like Octogone we just announced. We expect it to close in Q3, yeah? But do we really know? Could it be a Q2 closing, yeah? It's really in the hand of regulators and lawyers and--which makes the timing very, very difficult to predict. But very much so, the way Jim and I look at where we are, this is going to be yet again--not quite like last year, but it's going to be yet again a very strong M&A year.

Michael Young
Okay, makes sense. Thank you.

Rudy Adolf
So --

Operator

Ladies and gentlemen --

Rudy Adolf
If there are any--are there any more--operator, any more questions?

Operator
No, sir, we have no further questions. Back to you for closing remarks.

Rudy Adolf
Okay. So, thank you all. In closing, I'm extremely proud of the excellent quarter that we had, demonstrating the resiliency of our business as well as our strong momentum in fundamentals despite the challenging macro backdrop. Our scale and the diversity of our global partnership, as well as the nimbleness of our partners in our holding company team, were instrumental in helping us to deliver this level of performance.

We continue to invest in leading wealth management firms that complement our partnership and execute on an important strategic expansion into Switzerland, signing a top firm in that market and further expanding our TAM. We further enhanced our value-add services, providing substantial resources to our partner firms.

Our M&A momentum remains excellent, and we are well positioned to deliver another strong year in 2022 as we capitalize on the industry opportunity. Each of these elements contribute to the many points of upside in our business, which we believe are undervalued today but will deliver substantial future value to our current and prospective shareholders. Thank you all for your interest. Bye-bye.

Operator
This concludes today's conference. Thank you for joining us. You may now disconnect your lines.