Focus Financial Partners, Inc.
2022 Fourth Quarter and Full Year Earnings Call
February 16, 2023

Presenters
Rudy Adolf – Founder and CEO
Jim Shanahan – Chief Financial Officer
Rusty McGranahan - General Counsel
Tina Madon – Head of Investor Relations and Corporate Communications

Operator
Good morning. I would like to welcome everyone to the Focus Financial Partners 2022 Fourth Quarter and Full Year Earnings Call.

Joining today's call are Rudy Adolf, Founder and CEO; Jim Shanahan, Chief Financial Officer; Rusty McGranahan, General Counsel; and Tina Madon, Head of Investor Relations and Corporate Communications.

Mr. McGranahan, please go ahead.

Russell 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' 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 lists 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.

In addition, due to the recently announced acquisition proposal and exclusivity arrangement with Clayton , Dubilier & Rice, we will not be taking questions, following Rudy and Jim's prepared remarks.

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

Rudy Adolf

Thanks, Rusty. Good morning, everyone. And thank you for joining us, today. Despite the challenging macro environment correlated across virtually all asset classes throughout 2022, our full year performance was solid, finishing well in Q4 with strong momentum into 2023.

Our business demonstrated its resiliency and consistently outperformed relative to expectations. Our discipline, diversification and scale were instrumental in helping us not just to navigating the challenging market conditions but in positioning us to capitalize on the eventual recovery.

The depths and diversification of our global partnership, our strong M&A momentum, and our array of value-added programs were all instrumental to this outcome.

These elements are at the core of our competitive differentiation, reinforcing our leadership advantage in independent wealth management.

We generated solid results in 2022, growing our revenues by 19.2%, year-over-year, to approximately $2.1 billion. Our adjusted net income, excluding tax adjustments per share, was $3.62, and tax adjustments per share were $0.77, increasing over the prior year by 7.7% and 37.5%, respectively.

These results reflect our partners excellent job in managing their businesses and advising their clients.

They also further reinforce the value of the diverse and recurring nature of our revenues and the benefits of our variable cost base and our earnings preference.

Collectively, these attributes have enabled our business to weather volatile market conditions over multiple quarters, while mitigating the downside risk to our earnings.

2022 set another record for M&A in our industry, with transaction volumes, increasing nearly 11% over the prior year and achieving the 10th consecutive year of growth, according to economic partners.

DeVoe Research highlighted that sub acquisition volumes more than doubled in the last two years and were 50% higher in 2022 versus 2021.

Firms mentioned less than 1 billion in client assets, represented nearly 75% of public activity in 2022. We capitalized on this momentum, as did our partner firms. We closed 24 transactions last year, adding five new partner firms and completing 19 mergers on behalf of our partners, who took advantage of this substantial consolidation opportunity to accelerate their growth.

Our differentiated ability to source, structure and execute these accretive transactions remain a key part of our value proposition to growth-oriented firms. As the largest M&A team in the independent wealth management space, we continue to bring industry leading scale to the benefit of our partner firms, their clients and our shareholders.

In 2022, we increased our footprint in crucial Wealth Management markets across the US, adding excellent new partners with strong businesses, dynamic management teams, talented advisors, and long-standing client relationships. Our core value proposition of entrepreneurship, permanent capital and value-added programs continue to resonate, strongly.

We also expanded our international presence into Switzerland last year with our partnership with Octogone, further extending our partnership in countries with sizable independent Wealth Management sectors catering to high end ultra high net wealth clients remain an important priority.

We are off to a strong start in 2023, with seven transactions closed year-to-date, including one partner firm and six mergers, and we assigned four mergers, which we expect to close in the first quarter.

We continue to acquire high quality RIAs, and other independent wealth managers, but we're also selectively adding firms with unique capabilities that can benefit our partnership, such as the announced or acquisition of Origin Investments by our partner firm Kovitz at the start of this year.

When closed, Origin will add to Kovitz Private Real Estate Solutions at a time in alternative investments are becoming increasingly important to sophisticated investors. This transaction is expected to facilitate the ability of origin to offer alternative solutions to our partner firms' clients.

With about $1 billion of liquidity available to deploy, and our LTM cash flow available for capital allocation was $317.7 million, as of December 31.

Our M&A pipeline is strong, with a good mix of opportunities in the US and internationally. And our partners remain active in pursuing mergers to expand their businesses and recruit high quality talent.

We continue to structure transactions in an efficient way remaining nimble in our approach to achieving the best alignment between our objectives and seller interests, while staying within our 3.5 to 4.5 targeted net leverage ratio range.

However, we will continue to grow our partnership and add additional scale. We remain highly selective in our M&A process and disciplined in our capital allocation to ensure we execute transactions that generate incremental value for our shareholders.

2022 was another year in which the value of prudent fiduciary advice was evident, particularly in the unique challenges presented by markets and economies, last year. Our partners are trusted advisors in every aspect of their client's financial lives, beyond the investments.

These deep, multifaceted relationships result in continued high client retention, which drives our recurring revenues and the stability of our financial model.

We believe that the flight to comprehensive un-conflicted advice will continue to accelerate, as a result of last year's market correction, in turn accelerating the growth in client assets managed by the RIA industry the way it has in prior sectors.

Our partners benefited from our value-added programs last year, enabling them to meet the growing and highly personalized leads of a sophisticated high and ultra-high net risk client base.

By taking advantage of our scale and dedicated resources, our partners can deliver ever increasing value to their advisors and clients, which are essential catalysts for retention, referrals, and other sources of organic growth.

We continue to invest in areas such as alternative investment opportunities, lending, trust and insurance solutions, among others, with adoption by partners continuing to increase as these are the programs their advisors and clients want the most.

As 2023 gets underway, we anticipate volatile conditions may persist in the near-term, before markets begin to recover. We are confident that we will continue to, successfully, navigate this environment further reinforcing our resilience and the strength and consistency of our financial performance.

We remain highly disciplined capital allocators focused on achieving the appropriate risk reward in each transaction we do.

Similar to what we did in 2008 and 2009, in 2020, we are actively positioning ourselves for the market recovery. For every 2020, there is a 2021. We are uniquely positioned in a multi-trillion-dollar global industry experiencing in non-market correlated secular shifts driven in part by the need of founder succession and scale.

While transaction volumes continue to climb each year, we believe industry consolidation is just beginning, presenting an opportunity that will continue for years to come.

Our diverse and growing global partnership creates enduring scale advantages, reinforcing the sustainability of our strong growth over the long-term and uniquely positioning us to create significant value to our shareholders. For these reasons, Rajini, Lenny and I are excited about the outlook for focus as we continue to expand our industry leading position.

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

Jim Shanahan

Good morning, everyone. Our business further demonstrated its resiliency in 2022 with solid growth and financial performance and strong M&A momentum. Our diverse recurring revenue stream, variable management fee structure, and the strong economic alignment we have with our partners have withstood the volatile macro environment, over the last year.

We are executing well and remain confident that we will weather the ongoing challenges and be well positioned to capitalize on the growth opportunity, once markets recover.

Our partners have taken the uncertain macro environment in stride and are doing an excellent job working with their clients. The market events of 2022 reinforce the value of experienced trusted advisors, deep client relationships, and balanced portfolio structure to deliver growth, over the long-term.

Now let's turn to our Q4 and full year P&L. Our Q4 results were solid and exceeded our estimates on all measures. Our revenues were $547.7 million, up 4.5% year-over-year, and 6.3% above the top end of our guidance of $505 million to $515 million.

This is primarily due to the year-over-year change in organic revenues, which were negative 3.5% versus our initial estimate of negative 10%. Our organic revenues were impacted by the volatile market conditions in 2022.

Our revenue outperformance of $32.7 million was primarily related to higher than anticipated non-market correlated revenues from our family office firms, due to client activities and year-end value dealing. Approximately $7 million of this amount won't repeat in Q1 but could recur in future quarters.

Our Q4 adjusted EBITDA was $136.7 million, increase in 5.9% year-over-year, and our adjusted EBITDA margin was 25%, above our estimate of approximately 23%. The revenue of performance I just walked through contributed to a portion of this increase.

The remainder was attributable to variable compensation, where cash compensation and related expenses were, sequentially, lower by approximately $3 million. Compensation as percentage of revenue, which includes the effect of M&A transactions we closed in Q4 declined sequentially by 2.3 percentage points.

Our Q4 adjusted net income, excluding tax adjustments per share, was $0.79 declined 16% year-over-year. This reduction includes the impact of higher interest expense due to the 2022 increase in the LIBOR and SOFR rates, as well as a pre-tax $7.4 million increase in other expense, primarily associated with a write-off associated with an insurance receivable. Our Q4 tax adjustments per share was $0.20 cents, 25% higher, year-over-year.

For the full year, our revenues were approximately $2.1 billion, a 19.2% increase over the prior year, driven partly by an organic revenue growth rate of 8.5% for the same period. Our full year adjusted EBITDA was $537.5 million, 19.1% higher, year-over-year. Our adjusted EBITDA margin was 25.1%, unchanged from the prior year. We are proud of this achievement, given the market volatility in 2022.

Our full year adjusted net income, excluding tax adjustments per share, was $3.62, 7.7% higher than the prior year. Our full year tax adjustment per share was $0.77, increase in 37.5% for the same period, reflecting the growth in our tax shields, due to M&A activity. The tax efficiency of our business remains a significant and growing economic benefit to our shareholders.

Our 2022 M&A activity reflected strong momentum throughout the year. As Rudy highlighted, we closed 24 transactions, including five new partner firms and 19 mergers. In Q4, we closed nine transactions, including two new partner firms that contributed approximately $3.1 million of revenue and $1 million of adjusted EBITDA with an adjusted EBITDA margin of approximately 31% for the quarter.

On a full quarter basis, we estimate that these firms will contribute approximately $5 million and $1.8 million in revenues and adjusted EBITDA, respectively.

Now, let's turn to our Q4 expenses and cash flow. Management fees were $132.7 million or 24.2% of revenues, slightly up sequentially due to the Q4 revenue outperformance.

Our non-cash equity compensation expense was 1.5% of our Q4 revenues, in line with our expectation, and we anticipate that this expense will be approximately 1.4% of our estimated Q1 revenues.

As of December 31st, our LTM cash flow available for capital allocation was $317.7 million, reflecting the resiliency of our cash flows during a volatile market year. We paid cash earnout obligations of $32.6 million in Q4, and we estimate that we'll pay approximately $24 million in earnouts in Q1.

The deferred deal consideration, which involves paying a portion of the deal consideration at the time of closing and a portion several years from the timing of closing creates long-term liabilities for us in the form of deferred cash payments. These payments are in addition to the contingent consideration payments that we make.

To help investors understand the amount and timing of these deferred payments, we have provided disclosure in the F pages of our 2022 10-K, as well as on Page 24 of our earnings supplement.

Now, for a few words on our Q1 P&L expectations. We estimate that our Q1 revenues will be in the range of $560 million to $570 million. This estimate includes the real estate related performance fees we discussed on our third quarter call that we anticipate will add approximately $10 to our Q1 revenues, and the sequential decline of $7 million from Q4 revenues that will not repeat in Q1.

We estimate that our year-over-year organic revenue growth rate will be in the range of 1% to 3%, and we estimate that our Q1 adjusted EBITDA margin will be approximately 24%, which excludes any expenses associated with the Clayton, Dubilier & Rice process.

Now, turning to our balance sheet, we ended Q4 with approximately $2.6 billion of debt outstanding and our net leverage ratio was 4.19 times, slightly under our estimate of 4.25 times.

We anticipate that our Q1 net leverage ratio will be approximately 4.3 times. We continue to remain flexible in how we structure transactions, such as the deferral structure I mentioned previously, and will remain committed to our 3.5 to 4.5 net leverage ratio range.

We refinanced a portion of our debt in November and raised the new $240 million term loan, the details of which can be found on Pages 26 and 27 of our earnings supplement.

We took advantage of a window in the credit markets to extend the maturity on s $1.6 billion tranche of our term loan for 2024 to 2028 and to extend the maturity of our $650 million revolver to 2027, reducing the duration risk of our borrowings.

We also converted our remaining LIBOR borrowings to SOFR; $850 million of our outstanding debt has SOFR swapped to a fixed weighted average rate of 53 basis points, plus a spread of 325 basis points. The remaining amount of our outstanding debt is a floating SOFR rate, with a spread of 250 to 325 basis points.

Our new Term Loan A has a nine-month delayed draw feature, giving us added flexibility. While wider spreads create some incremental interest expense headwind for us, we continue to focus on prudently managing our capital structure and maturity ladder.

At year end, our new term loans, together with our undrawn revolver and cash balance gives us approximately $1 billion of firepower, as we anticipate another strong year of M&A activity. Additionally, our LTM cash flow available for capital allocation was $317.7 million, last year.

As Rudy noted, we are highly disciplined in allocating capital, even more so given the increase in interest rates over the past year.

In closing, we delivered a solid year of growth and performance, despite the volatile macro backdrop with the hallmarks of how we invest and grow our business again clearly evident. Our business demonstrated its resilience, supported by a diverse base of recurring revenues.

Our partners generated strong performance and serve their clients well, positioning themselves to strong growth, as markets recover.

We continue to navigate the ongoing market challenge, as well. We remain highly disciplined in how we deploy capital, position ourselves to take advantage of the enormous growth opportunity ahead, once markets begin to recover.

I'll now turn the call back to Rudy for closing remarks.

Rudy Adolf
Thank you, Jim. In closing, I want to reiterate how proud we are of what our business and our partner firms accomplished last year. They navigated the difficult market well and their deep expertise and long-term orientation were evident. They demonstrated the value of prudent fiduciary advice and delivered outstanding service to their clients.

As I said before, it is environments like we have experienced last year, when their industry leadership and the value of what they do really shows positioning them for strong growth in financial performance, as financial markets recover.

Now, as Rusty indicated, given our recently announced ongoing discussions regarding a potential transaction with Clayton, Dubilier & Rice, we will not be opening up the lines for Q&A as we normally do but want to thank everyone, as always, for your time and interest in Focus.

Operator
Thank you. This concludes today's teleconference. You may disconnect your lines at this time and thank you for your participation and have a great day.