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LPL Financial
Q2 2020 Earnings
Prepared Remarks

Notice to Investors: Safe Harbor Statement

Statements in these prepared remarks regarding LPL Financial Holdings Inc.'s (together with its subsidiaries, the "Company") future financial and operating results, plans, priorities, strategies and outlook, including forecasts and statements relating to market trends, economic conditions, investor engagement, market opportunities and the Company's future growth, market share, investments, affiliation models, business development results, capabilities (including technology and digital capabilities), services, service model, client experience, improvements, business mix, brokerage and advisory asset levels, gross profit*, advisory fees, return on assets, client cash balances and yields (including the future fixed rate portion of the portfolio), expenses (including Core G&A* outlook for 2020), capital deployment, returns to shareholders and long-term value, as well as any other statements that are not related to present facts or current conditions or that are not purely historical, constitute forward-looking statements. These forward-looking statements are based on the Company's historical performance and its plans, estimates, and expectations as of July 30, 2020. Forward-looking statements are not guarantees that the future results, plans, intentions, or expectations expressed or implied will be achieved. Matters subject to forward-looking statements involve known and unknown risks and uncertainties, including economic, legislative, regulatory, competitive, and other factors, which may cause actual financial or operating results, levels of activity, or the timing of events, to be materially different than those expressed or implied by forward-looking statements. Important factors that could cause or contribute to such differences include: the spread of COVID-19 and its direct and indirect effects on global economic and financial conditions; changes in general economic and financial market conditions, including retail investor sentiment; changes in interest rates and fees payable by banks participating in the Company's client cash programs; the Company's strategy and success in managing client cash program fees; changes in the growth and profitability of the Company's fee-based business; fluctuations in the levels of advisory and brokerage assets, including net new assets, and the related impact on revenue; effects of competition in the financial services industry, and the success of the Company in attracting and retaining financial advisors and institutions; whether retail investors served by newly-recruited advisors choose to move their respective assets to new accounts at the Company; the effect of current, pending and future legislation, regulation and regulatory actions, including disciplinary actions imposed by federal and state regulators and self-regulatory organizations, and the implementation of Regulation BI (Best Interest); the costs of settling and remediating issues related to regulatory matters or legal proceedings, including actual costs of reimbursing customers for losses in excess of the Company's reserves; changes made to the Company's services and pricing, and the effect that such changes may have on the Company's gross profit* streams and costs; execution of the Company's plans and its success in realizing the expense savings, synergies, service improvements and/or efficiencies expected to result from its investments, initiatives, acquisitions and programs; and the other factors set forth in Part I, "Item 1A. Risk Factors" in the Company's 2019 Annual Report on Form 10-K, as may be amended or updated in the Company's Quarterly Reports on Form 10-Q or other filings with the SEC. Except as required by law, the Company specifically disclaims any obligation to update any forward-looking statements as a result of developments occurring after July 30, 2020, even if its estimates change, and statements contained herein are not to be relied upon as representing the Company's views as of any date subsequent to July 30, 2020.

Actual remarks made on the Company's earnings conference call could vary from the prepared remarks presented here. A webcast replay of the Company's earnings conference call will be available on the Investor Relations section of the Company's website, investor.lpl.com, until August 20, 2020. Please refer to the Company's earnings release for additional information.

*Notice to Investors: Non-GAAP Financial Measures

The prepared remarks set forth herein include discussion of certain non-GAAP financial measures. At the time these remarks were made, listeners were referred to the Company's earnings release, which had been previously published on the Company's website at investor.lpl.com, and which contained reconciliations of such non-GAAP financial measures to comparable GAAP figures. Management believes that presenting certain non-GAAP financial measures by excluding or including certain items can be helpful to investors and analysts who may wish to use some or all of this information to analyze the Company's current performance, prospects, and valuation. Management uses this non-GAAP information internally to evaluate operating performance and in formulating the budget for future periods. Management believes that the non-GAAP financial measures and metrics discussed herein are appropriate for evaluating the performance of the Company. These non-GAAP financial measures include but are not limited to EPS prior to Amortization of Intangible Assets, Gross Profit, Core G&A, EBITDA and Credit Agreement EBITDA.

Dan Arnold, President and CEO

Thank you, [Operator], and thanks to everyone for joining our call today. Over the past quarter, in the face of a challenging operating environment, our advisors have responded with resilience, flexibility, and ingenuity. I want to acknowledge the essential roles they are playing by providing much-needed financial advice to millions of Americans, while at the same time pivoting their own practices to work remotely. I also want to thank our employees for their ongoing commitment and dedication to our mission of taking care of advisors, so they can take care of their clients.

Now…while the environment we are operating in has changed, our principles remain the same: we believe a good strategy, matched with extraordinary execution, and alignment with a mission-driven culture, will drive long-term growth and value. Following those principles, in the second quarter we continued to focus on executing the key components of our business priorities while also moving forward on our strategic plan. Today I will share color on both those areas.

Starting with our business results, organic growth remained solid, as second quarter net new assets totaled $13 billion, which translated to a 7.8 percent annualized growth rate. This was our third quarter in a row at 7 percent or higher, and was driven by continued strength across new store sales, same store sales, and retention.

In the second quarter, Recruited Assets were a new high at $11.1 billion. These results, against a backdrop in which industry advisor movement was down by over 30 percent from a year ago, are a testament to the appeal of our model and the performance of our business development team. Looking at the past year, recruited assets were nearly $39 billion, which is also a new high for the team.

With respect to the advisor service experience, we were able to pull forward solid outcomes in a challenging operating environment as our Net Promoter Scores remained consistent with the increased levels we delivered in Q1. Additionally, our retention was at a new high of over 98 percent for the first half of the year, as the flexibility of our affiliation models, evolving capabilities, and enhanced service experience continued to resonate with advisors.

These key business results also led to solid financial outcomes, with second quarter EPS prior to intangibles of $1.42.

Now…while we remained focused on operating the business in the second quarter, the influence of the remote work environment created new challenges and opportunities to solve for. As an example, to help advisors effectively operate remotely, we developed a bundle of new and enhanced capabilities including: an online calendaring solution for advisors and their clients to schedule time to meet virtually; intra-office instant messaging for advisors to stay connected with their staff remotely; and a more digitized centrally managed platform experience with greater model flexibility.

We also continue to evolve how we engage with our advisors in the new and more virtual landscape. Instead of cancelling our national advisor conference this summer, we pivoted to a fully digital experience. Similar to the format of our traditional in-person meeting, the three-day program will include: live streamed general sessions, a mix of breakout meetings, technology demos, a virtual sponsor exhibit hall, and online networking. With the event now online, we can potentially reach all 17,000 of our advisors and their staff, rather than the 5,000 who might normally attend in person. As we look forward, we expect new virtual approaches like these will become another way that we can support our advisors and their clients over time.

Let's now turn to our progress executing on our strategy. As we look ahead, we continue to see growing demand for advice and believe we are better positioned than ever to serve our advisors and compete for additional market share. In light of this, we remain focused on executing the strategy we've shared with you in the past. And while that strategy has not changed, we have evolved from three strategic plays to four, which enhances our focus on how we innovate and execute on our strategic agenda. You can see our updated framework in our Investor Presentation.

With that context, let's now walk through our progress on our strategic priorities, starting with our first strategic play. This play involves meeting advisors where they are in the evolution of their practices by winning in our traditional markets while also leveraging new affiliation models to expand our addressable markets from $4 trillion to $13 trillion.

With respect to our traditional markets, the appeal of our model continues to attract more advisors onto our platform and strengthen our pipeline. In addition, the continued evolution of our digital capabilities within the sales process and for advisor onboarding has proven to be an increasing source of competitive advantage. As a result, interest from prospective advisors continues to grow, and our pipeline is the largest in our history.

Another opportunity to grow in our traditional markets is by increasing our market leadership in the third party bank channel. Yesterday, we announced that we reached an agreement with M&T Bank to transition its wealth management business onto our platform. M&T is a Top 25 U.S. bank with approximately $20 billion in brokerage and advisory assets and 170 financial advisors. They will become our largest financial institution client when they onboard next year. We look forward to the opportunity to help them serve and support their clients, expand their value proposition, and contribute to growth in their business.

With respect to our new affiliation models, in June we launched our Independent Employee offering. We are seeing solid early interest from prospective advisors, and we expect the model to contribute to our opportunity set, pipeline, and results going forward.

We are also using M&A of advisor-owned practices as an additional source of growth. The two acquisitions we announced over the past quarter, Lucia Securities and E.K. Riley, have approximately 55 advisors and $3.5 billion of assets combined. Approximately 95 percent of advisors across those two firms have committed to join, and both transactions are on track to close later this year.

Our second strategic play is focused on providing capabilities that help advisors differentiate and win in the marketplace. This in turn helps existing advisors grow their practices and attracts new advisors to our platform.

Within this play, we are focused on equipping advisors with digital capabilities that help increase their accessibility, deepen their relationships, attract new clients, and lower their costs. In that spirit, over the past quarter we began the rollout of our new Mobile App. This solution goes beyond typical transactional information to create a new way for advisors to help their clients digitally engage in their personal financial journeys. The tool enables advisors to personalize the interface for their practice and individual clients – while also providing clients with enhanced views of progress towards their financial goals. As we look ahead, we plan to continue to invest in this area to help advisors enhance the overall experience for their clients.

Let's next move to our third strategic play, which involves creating an industry-leading experience to delight advisors and their clients, which in turn increases our ability to attract and retain advisors. The main components of this strategic play are transforming our service model into a client care model and delivering instantaneous processing driven by robotics and artificial intelligence.

As part of our service model transformation, I want to highlight two technology-driven enhancements that we made over the past quarter. First, we scaled our Omni-channel capabilities from 3,000 advisors to nearly 16,000. This means nearly all of our advisors benefit from the combination of interactive voice recognition with skills-based routing to a service professional who is trained and certified to answer their specific question.

Second, we introduced new speech analytics capabilities to enhance our quality management at scale. We are now using artificial intelligence and machine learning to capture and score the sentiment of each service call. This positions us to quickly identify emerging service issues and more systematically and proactively address them. At the same time, we can also use this data to enrich how we develop and manage our service professionals. Our advisors continue to share positive feedback on our service model transformation and tell us that it is a key contributor of our increased net promoter scores and retention levels.

Our fourth strategic play is focused on helping advisors run the most successful businesses in the independent marketplace - using innovations such as outsourced business solutions and advisor-focused capital solutions.

With respect to Business Solutions, in early June, we introduced our newest offering, the Assurance Plan. As context, across our industry, 70 percent of advisors don't have a succession solution in place. The Assurance Plan can help our advisors with this challenge by protecting the value of their businesses in the event of an unplanned exit. With this plan, we provide an annual valuation, and we facilitate a commission-free sale to another qualified LPL advisor at a guaranteed, minimum purchase price. This gives advisors the peace of mind that their family and clients will be taken care of, and it strategically positions us to continue serving clients and assets through succession events. After launching in June, we signed up over 150 subscribers in the first few weeks. We look forward to continuing to provide this solution along with our broader portfolio of offerings to help advisors run and grow their businesses.

Before closing, I also want to share that we have thought a lot about the growing need in our businesses and our country to address issues of inequality. To inform our learning, the Management Committee and I have been talking with business leaders, advisors, and employees in the Black community, while simultaneously engaging with all members of the LPL family in the spirit of understanding and building empathy. Within LPL, there is broad consensus around a desire to take action to make a difference. In order to do that, we are creating a strategy to promote racial equality and equity at LPL. There are definitely no easy or quick fixes to solve these challenges. But we are committed to making progress for our advisors and their clients, our employees, and future generations.

In summary, in the second quarter, we continued supporting our advisors and their clients while driving growth and increasing our market leadership. As we look ahead, we see an opportunity to not just return to business as usual, but rather create a future that is better than ever for our advisors and their clients. We believe that continuing to execute on our strategy will achieve this goal and create long-term shareholder value.

With that, I'll turn the call over to Matt.

Matt Audette, CFO

Thank you, Dan, and I'm glad to speak with everyone on today's call.

While the macro environment remains uncertain, we have never been more certain about the importance of the role our advisors play in helping their clients achieve their financial goals and dreams. That is why we continue to invest to provide an industry-leading value proposition for our advisors to serve their clients and win in the marketplace. These investments in turn help us drive growth, and in Q2, we generated the highest organic growth rate in our history. So as we look ahead, we are excited about the opportunities we see to continue serving our advisors, growing our business, and creating long-term shareholder value.

Now let's turn to our second quarter results, starting with total brokerage and advisory assets. They were $762 billion, up 14 percent from Q1, driven by continued organic growth and higher equity markets.

Looking at organic growth, total net new assets were $13.0 billion, or a 7.8 percent annualized growth rate. This was the highest quarterly level we have recorded, and double our pace from a year ago.

Moving to recruiting and retention, which are two key drivers of organic growth, both reached new highs in the second quarter. Recruited assets were $11.1 billion, and retention was 98.6 percent year-to-date.

Looking at our business mix…we continued to see positive trends in Q2. Advisory assets increased to over 49 percent of total assets, primarily driven by advisory net new assets of $10.2 billion, or a 13 percent annualized growth rate. Within our advisory platforms, centrally managed net new assets were $1.3 billion, or an 11 percent annualized growth rate.

Now let's turn to our Q2 financial results. Strong organic growth combined with continued expense discipline led to EPS prior to intangibles of $1.42.

Looking at commission and advisory fees net of payout…they were $131 million, down $31 million from Q1. The decrease was primarily driven by seasonally higher production bonus expense, lower advisory fees following the Q1 equity market decline, and lower sales commissions.

Moving on to asset-based revenues…Sponsor revenues were $131 million in Q2, down $3 million sequentially, as average assets decreased in the quarter.

Turning to client cash revenues, they were $116 million, down $35 million from Q1, primarily driven by lower short-term interest rates. Looking more closely at client cash balances, they remained elevated throughout the quarter and finished Q2 at $45 billion.

I also want to give you an update on our ICA portfolio. As a reminder, when ICA balances increased rapidly in March, we took action that same month to secure $5 billion of new variable rate capacity. This allowed us to minimize the amount of overflow balances, which currently have a yield close to 0. In Q2, we continued that work by adding another $5 billion of variable rate capacity, which allowed us to move the remaining overflow balances to higher yielding contracts. We also continued to grow our fixed rate portfolio by adding another $1 billion of fixed rate balances, bringing the total to over $13 billion. I would note that given the flatness of the yield curve, we added these new balances at the 1-year point, which was at about 60 basis points at the time.

As for client cash yields, our Q2 ICA yield was 127 basis points, down 68 basis points from Q1. The decrease was primarily driven by the full quarter impact of lower short-term interest rates, partially offset by the benefit of the Q2 ICA portfolio enhancements that I highlighted.

Looking ahead to Q3, our ICA yield will reflect the remaining impact of lower LIBOR rates, as well as the maturity of half a billion of fixed rate balances. Given these factors, and where interest rates, client rates, and cash balances were at the end of Q2, we expect our Q3 ICA yield to be around 115 basis points.

Moving on to Q2 transaction and fee revenues… they were $119 million, down $18 million sequentially. The decrease was primarily driven by lower transaction volumes following the record Q1 activity levels. Looking ahead to Q3, volumes have returned to more normalized levels, which on a run rate basis would result in a decline in transaction revenues of around $5 million from Q2.

Now let's turn to expenses, starting with Core G&A… it was $222 million in Q2, roughly flat to Q1. This brings our Core G&A expense for the first half of the year to an annualized run rate of about $890 million, which is below the low end of our outlook range. Looking ahead, as our investments are resonating with advisors and driving record levels of growth, we feel confident in our spending plans for the second half of the year. At the same time, the operating environment remains volatile, so we plan to stay flexible and dynamic on expense management. Given these factors, we continue to manage to the lower half of our Core G&A range of $915 to $940 million.

Moving on to promotional expenses, they were $45 million, down $13 million sequentially, as we had no major conferences in Q2. Looking ahead to Q3, we will host our national advisor conference. And while we pivoted to a virtual format, we are still investing to create a meaningful and engaging conference experience for our advisors, including a new digital platform, content over several days, and outside speakers. Given the conference, as well as continued growth in transition assistance from our recruiting success, we expect our Q3 promotional expense to be around $60 million.

Moving on to capital allocation…Our framework continues to be investing in organic growth first and foremost; pursuing M&A opportunities where appropriate; and returning excess capital to shareholders.

Looking at the components of our framework, organic growth continues to provide the highest and most attractive returns on our capital. Our investments here are working well, so we plan to continue prioritizing organic growth as we deploy capital. M&A can also provide compelling returns, and while the timing is inherently difficult to predict, we want to remain positioned to take advantage of opportunities should they arise. As for capital returns to shareholders…given our focus on preserving capital for organic growth and M&A - combined with the continued uncertainty in the macro environment - we plan to remain paused on share repurchases for now, though we will stay flexible and dynamic as we move forward.

In closing, we delivered another quarter of strong results in Q2, including the highest organic growth rate in our history. And as we look forward, we remain excited about the opportunities we see to continue investing to serve our advisors, grow our business, and create long-term shareholder value.

With that, Operator, please open the call for questions.