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LPLA - Q1 2018 LPL Financial Holdings Inc Earnings Call

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PRESENTATION

Operator

Good evening, and thank you for joining the First Quarter 2018 Earnings Conference Call for LPL Financial Holdings Incorporated.

Joining the call today are President and Chief Executive Officer, Dan Arnold; and Chief Financial Officer, Matt Audette. Dan and Matt will offer introductory remarks, and then the call will be opened for questions. (Operator Instructions) The company has posted its earnings press release and supplementary information on Events section of investor.lpl.com.

Today's call may include forward-looking statements, including statements about LPL's financial future revenue, expenses and other financial and operating results, business strategies and plans as well as other opportunities and potential risk that management foresees, such forward-looking statements reflect management's current estimates or belief and are subject to risk and uncertainties that may cause actual results to differ materially. The company refers listeners to the safe harbor disclosures contained in the earnings press release and the company's latest SEC filings, to appreciate those factors that may cause actual financial or operating results or the timing of matters to differ from those contemplated in such forward-looking statements.

During the call, the company will also discuss non-GAAP financial measures governed by SEC Regulation G. For any reconciliation of such non-GAAP measures to comparable GAAP figures, please refer to the company's earnings release, which can be found at the company's website, investor.lpl.com.

With that, I'll now turn the call over to Mr. Arnold.

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Thank you, Sonia, and thank you to everyone for joining our call. We began 2018 with another quarter of business and financial growth. We focused on our strategic priorities of growing our core business, onboarding and assimilating NPH Advisors and executing with excellence, altogether, we feel good about the progress we made and the results we generated in the first quarter.

Let's now turn to our business results, starting with our advisers. Their differentiated solution in the marketplace was recently recognized in a third-party study by Cogent. It found that retail clients ranked LPL advisers first in net customer loyalty among 30 leading distributors. This is a testament to the appeal of our advisers' business model and the quality of the service they provide.

Moving to brokerage and advisory assets, we finished the quarter with $648 billion or 22% from a year ago, and up 5% from the fourth quarter. This was driven by a combination of organic growth and the onboarding of NPH assets.

Looking in more detail at organic growth, total net new assets were $2.9 billion. This was primarily driven by advisory net new assets of $6.9 billion or 10% percent annualized growth rate. As a result, advisory assets are now 47% of our total assets prior to NPH.

On our corporate advisory platform, annualized growth was 11%, supported by the strategic pricing changes that went into effect in January. Additionally, Centrally managed inflows were nearly $2 billion this quarter as advisers continued to leverage our outsourced portfolio of management services to drive scale into their business.

Our recruiting efforts contributed to our net new assets as we recruited approximately $4 billion of assets in the first quarter, while production retention was 96%. We believe these first quarter results are consistent with our strategy to drive greater utilization of our advisory, corporate and centrally-managed platforms.

Turning to NPH. We had $36 billion in net new assets this quarter, primarily driven by the second wave of advisers who onboarded in February. Looking at both waves together, we have added approximately $70 billion of assets and 1,900 advisers and we continue to expect total net new assets from NPH to be up to $75 billion. We're excited about the quality of the advisers we attracted and the opportunities to support them as they leverage our platforms and services.

Additionally, during this acquisition, we created new capabilities, strengthened our M&A acumen and identified areas of opportunity that will enhance our future adviser onboarding, either in recruiting or M&A.

Moving to our financial results, we continue to drive growth and operating leverage in the first quarter. Gross profit increased 23% year-over-year driven by double-digit growth in advisory fees, trailing commissions, sponsor revenues and cash sweep.

As for sales commissions, prior to NPH, they were up sequentially for the second straight quarter. We also remain disciplined on expenses. This combination led to EPS of $1.01, which is nearly twice our level from a year ago.

Matt will review our financial performance in greater depth. Now that we have reviewed our business and financial results, I'd like to discuss our strategic priorities starting with core business growth. We remain focused on driving organic growth as well as exploring M&A opportunities that align with us strategically, financially and operationally.

With respect to organic growth, we are focused on helping advisers differentiate and win in the marketplace by providing them with enhanced capabilities and competitive pricing. Looking more specifically at capabilities, we continue to enhance solutions and tools to help our advisers effectively serve their clients and contribute to their growth.

As a reminder, in 2016, for advisers on our corporate platform, we rolled out a mutual fund no-transaction-fee program or NTF network. This lowered the cost of, and simplified access to, active management for retail clients and help drive greater mutual fund flows. This summer, we plan to rollout a similar NTF network on our hybrid platform. This new offering is a more competitive solution for advisers and their clients. We believe it will be one of the most compelling mutual fund NTF lineups available in the marketplace.

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In the near term, we expect the financial impact to be roughly neutral for us as we anticipate lower transaction revenue will be offset by increased sponsor revenue. But over time, we expect this capability will enhance appeal of our advisory solutions and of active management, both of which can increase our gross profit.

Let's now next turn to pricing. Over the last few years, we have lowered the cost for advisers to outsource their portfolio and risk management through our centrally managed and corporate advisory platforms. These changes have contributed to greater utilization and growth of assets on these platforms. Building on these outcomes, in January 2019, we will extend this strategy. We will lower the price of our corporate platforms for advisers with $25 million to $50 million in advisory assets. We believe this will attract more assets to the corporate platform as additional advisers can now more cost-effectively outsource risk management to us.

In the first quarter, we also continued to innovate with our recruiting strategy, including a temporary increase in transition assistance. As context, we have a structural advantage over our competitors as the combination of our scale and self-clearing capabilities make assets on our platform more valuable. We also have a strong balance sheet that positions us to invest in organic growth. As a result, we are testing the impact of a temporary increase in recruiting transition assistance for adviser practices that would use more of our services. With this approach, we are staying financially disciplined, while generating a compelling return on investment.

While we are early in our efforts, we believe this will contribute to future organic growth. Let's now turn to our second strategic priority, executing with excellence. We are focused on increasing the quality of our technology and service and making it easier for advisers and their clients to do business with us. We are modernizing our service model to take friction out of client interactions and provide timely and relevant information when and where our clients need it. Aligned with this focus, we launched our 100 wins in 100 days initiative with the goals of simplifying policies and procedures, enhancing our ClientWorks technology platform and improving service interactions.

For example, in April, we introduced a more efficient trading experience that reduces the number of steps necessary to execute a trade by over 80%. Over time, we expect wins like these will have a compounding effect that can enhance our advisers experience, simplify our operating environment and support long-term growth. We plan to invest over $100 million in technology this year to support these and other initiatives.

Before closing, I thought it would be helpful to update you on a few regulatory topics. First, you may have read about our blue sky settlement framework. As context, this matter is a historical control issue related to certain individual equity and fixed income transactions, which represent a relatively small part of our business. The vast majority of our business, including most exchange-listed securities, mutual funds, annuities and insurance is not at issue with this matter. We are now focused on offering remediation to any investors who may have been affected. We take our compliance obligations seriously and we have invested in our compliance and risk-management capabilities, which are helping us address this matter. Matt will cover how to think about this financially.

Next, let's turn to the fiduciary standard for brokerage accounts. It appears the DOL fiduciary rule will likely be vacated. While the SEC has introduced a proposal for a best interest standard for brokerage accounts. As a reminder, we believe in a higher standard of care and preserving choice. In preparation for the DOL rule, we implemented many product, disclosure and operational changes across our brokerage platform, both for retirement and taxable accounts. As a result, we believe our advisers are well positioned to support their clients and differentiate their practices regardless of the outcome of the SEC rule.

We will actively work with the SEC to provide our perspective and insight as they continue their progress on a best-interest standard. Finally, FINRA issued a proposal to reduce broker-dealer oversight responsibility on outside advisory activity. We are supportive of the concept of this rule, which preserves choice for advisers in how they operate their practices and serve their clients. Strategically, we are also well positioned to support our advisers as offering both a corporate and a hybrid platform enables choice.

From a financial perspective, our hybrid RIAs have only $10 billion of assets at outside custodians. And we charge about $2 million annually to oversee those calls. As for timing, because of the regulatory rule-making and public comment process, we may not have a final rule for an extended period of time. Irrespective of the time line, we're committed to working with FINRA on this matter in continuing to provide choice to our advisers.

In summary, we are pleased to start the year with another quarter of business and earnings growth. We plan to remain focused on our strategic priorities of growing our core business and executing with excellence. We believe our strategy positions us well to serve and support our advisers, drive profitable growth and create long-term shareholder value.

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

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Thank you, Dan. And I'm glad to speak with everyone on today's call. We had a good start to the year in Q1, nearly doubling earnings per share from a year ago. We continue to grow assets and gross profit, while remaining disciplined on expenses to drive operating leverage.

As a result, our Q1 EPS prior to intangibles was $1.11. Additionally, if we look at our results prior to NPH, EPS prior to intangibles was $1.36. We are pleased to start the year with these strong business and financial outcomes.

Let's now go to our business results in greater depth, starting with brokerage and advisory assets. We finished the quarter at $648 billion, up $32 billion or 5% sequentially, driven by organic growth and NPH onboarding, partially offset by lower equity markets.

Total net new assets were $38.9 billion for the quarter, including $2.9 billion of organic net new assets and $36 billion from NPH.

Now let's look at our organic growth in more detail. Net new advisory assets were $6.9 billion or a 10% annualized growth rate. This included $2.2 billion in conversions from brokerage to advisory and advisory assets prior to NPH increased to 47% of total assets.

Within advisory, 2/3 of our inflows were on the corporate platform, totaling $4.3 billion or on 11% annualized rate. As for centrally managed platforms, inflows increased to $1.8 billion or a 22% annualized rate. These results highlight 3 positive trends that benefit our gross profit return on assets over time. More assets converting from brokerage to advisory, and within advisory, more assets moving on to our corporate and centrally-managed platforms. We are pleased with the progress we made this quarter as our investments in enhanced capabilities and lower price help drive growth.

Turning back to our results. Q1 net new assets from NPH included $29.9 billion of brokerage and $6.2 billion of advisory assets. In total, we have onboarded $70.2 billion through the end of Q1 and we continue to expect up to $75 billion of total assets to transfer as we have some remaining direct brokerage business from wave 2 that we expect to transfer in the second quarter.

We are also seeing NPH assets begin to convert from brokerage to advisory with $0.3 billion in the first quarter, bringing our total conversions to $2.5 billion for Q1.

Let's next turn to Q1 gross profit. It was $464 million, up $61 million or 15% sequentially. Prior to NPH, it was $440 million, up $41 million or 10% from Q4 with increases across all of our major gross profit categories.

Moving to commission and advisory fees net of payout. They were $136 million in Q1, up $31 million or 30% sequentially. Prior to NPH, they were up $22 million or 22% sequentially, primarily driven by higher advisory fees and trailing commissions, which rose along with average asset levels.

Sales commissions prior to NPH also increased slightly, despite 2 fewer trading days in Q4. And as a reminder, our payout rate increases seasonally from Q1 to Q2. Last year, it increased by about 80 basis points, which amounted to a $7 million increase in production expense.

Turning to the corporate platform price reductions, which Dan covered. The lower pricing we announced last year went into effect this January. And increased our commission and advisory expense by about $3 million in the first quarter. We are seeing positive results as corporate advisory net new assets are growing at nearly double the rate they were in Q4 2016.

As a quick note, that pricing change is reflected as an increase in production bonus payout, which is a component of our total payout rate. Year-over-year, the bonus payout rate increased by about 30 basis points, primarily driven by this pricing change. The new pricing change that Dan highlighted for 2019 will go into effect next January. And we estimate it will initially reduce gross profit by about $2 million per quarter.

Overall, we believe this lower pricing will make our corporate platform even more compelling, grow at a faster rate and benefit our gross profit return on assets. As for asset-based fees, which includes sponsor and cash sweep revenues. Sponsor revenues were $115 million, up $10 million from Q4, primarily driven by higher asset levels as well as favorable repricing within our sponsor contracts.

Moving to cash sweep revenues, they were $104 million, up $16 million or 18% sequentially as higher short-term interest rates increased our yields. Client cash as a percent of assets finished Q1 at 4.6%, down from 4.8% in Q4. This Q1 level was primarily driven by investors remaining highly engaged in the market as well as NPH assets that onboarded having lower cash as a percent of assets than our overall average.

Looking at Q1 cash sweep yields, our ICA yield was 152 basis points, up 20 basis points from Q4, primarily driven by benefits from the December and March rate hikes. As we think about our Q2 ICA yield, we will have the remaining benefit of the March rate hike, partially offset by an increase in client deposit rates that went into effect in April, equivalent to a deposit beta of about 25% or 6 basis points on average.

Assuming no further benefits from interest rate increases, or changes to our deposit rates, we anticipate our Q2 ICA yield will be in the mid-160 basis point range.

Moving on to Q1 transaction and fee revenues. They were $117 million, up $14 million or 13% sequentially, primarily driven by 2 factors. First, Q1 is seasonally better for both transaction volumes and IRA fees. Second, volatility was elevated, especially in January and February and that led to high transaction levels.

Looking at Q1 in more detail, transaction revenues increased $8 million sequentially and IRA fees were up $2 million. Looking ahead to Q2, we would expect a seasonal decrease in IRA fees. As for volatility, we already saw it return to normalized levels in March and April. So if we see those levels continue in Q2, we would also expect transaction revenues to return to lower levels.

Now turning to expenses, starting with core G&A. In Q1, core G&A expense was $201 million, including $6 million of NPH onboarding cost and $13 million of NPH run rate cost. Prior to NPH, core G&A was $182 million, down slightly from Q4.

As we look ahead to core G&A prior to NPH for the rest of the year, we continue to expect to increase our investments over Q1 levels as planned. As for ongoing core G&A from NPH, we expect our run rate to be about $15 million per quarter. Additionally, we will have some remaining NPH onboarding cost through the rest of the year. Altogether, we continue to expect $800 million to $830 million of core G&A for 2018.

Moving on to Q1 promotional expenses, they were $67 million, up $7 million or 12% sequentially. Prior to NPH cost, promotion was $34 million in Q1, down $3 million or 9% sequentially. As for NPH promotional cost, they were $33 million, primarily driven by onboarding cost and cash assistance as well as $4 million of forgivable loan amortization.

Looking ahead to Q2, prior to NPH, our promotional expense will be driven, primarily by transition assistance, which varies quarter-to-quarter depending on a level of recruiting success. Additionally, we expect our conference expenses to increase by about $6 million as we held one of our major adviser conferences in April. As for NPH promotional expenses, we expect the quarterly run rate going forward to be approximately $7 million, primarily driven by forgivable loan amortization.

Turning now to regulatory expenses. They totaled $6 million for Q1, up $1 million sequentially, primarily driven by the increase in captive insurance premiums that we mentioned last quarter. Additionally, as Dan said, we have agreed to general terms with state regulators on a legacy matter. We expect the majority of these costs will be covered by our captive insurance company over the next few years along with some cost we expect to cover within our existing spending plans as we work to remediate any client transactions that may be affected. And as a reminder, the nature of regulatory expenses makes them inherently difficult to predict. Our actual expense could move up or down in any given quarter or year based on the size and timing of the matters and available captive coverage.

Moving to share-based compensation. It was $6 million in Q1, up $1 million from the prior quarter driven by the timing of annual grants. Looking ahead, we anticipate our Q2 level will be similar to Q1.

Turning to amortization of intangibles. It was $13 million in Q1, up $3 million sequentially as we recorded the intangibles from the first half of the NPH purchase price in December. We recorded the second half in Q1 and we continue to expect run rate expense of about $16 million per quarter starting in Q2.

As for interest expense, it was $30 million, up $1 million sequentially, driven by increased short-term interest rates. Looking ahead, we expect Q2 interest expense to increase $2 million to $3 million sequentially as LIBOR rates rose throughout Q1 and our floating rate debt repriced in late March.

Turning to taxes. Our Q1 effective rate was 22%. This is below our expected range of 27% to 29% because of 2 discrete items. Stock option exercises and the state tax matter in which we prevailed.

Going forward, a range of 27% to 29% is still the best way to think about our tax rate for the rest of the year.

Turning now to our run rate NPH EBITDA, which is prior to onboarding cost and cash financial assistance. Our prior estimate of $85 million of annual run rate EBITDA was based on the macro environment at the time of the transaction last August. Since then, we've had 2 rate hikes and the SMP has increased, but cash as a percent of assets has declined. Taking these factors together, we now estimate annual run rate EBITDA accretion of $90 million. As for timing, we continue to expect to reach the run rate by the end of year. And in Q1, we generated approximately $7 million of run rate EBITDA or roughly $26 million on an annualized basis.

Moving on to capital management. Our balance sheet remained strong in Q1 as our net leverage declined to 2.5x. Cash available for corporate use was $474 million, up $34 million from Q4. We also repurchased $61 million of shares in Q1, approximately twice the amount from last quarter and we paid $23 million in regular quarterly dividends. We feel good about our capital deployment in Q1. And our priorities remain investing for organic growth, taking advantage of M&A opportunities if they arise and returning capital to shareholders.

In closing, we are pleased to have delivered another quarter of strong business and financial results in Q1. We remain focused on growing assets and gross profit, staying disciplined on expenses to create operating leverage and deploying capital to drive growth and shareholder returns.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Steven Chubak of Nomura Instinet.

Steven Joseph Chubak - *Nomura Securities Co. Ltd., Research Division - VP*

Matt, wanted to start off with a question on deposit beta. Some of your competitors have cited some early signs of upward pressure on pricing just given higher yields on cash alternatives. You've retained your guidance of 25% to 50% medium term. I'm just wondering if that 50% terminal beta, is that still a reasonable expectation at year-end? And then just separately, it looks like the DCA and money market yields have exceeded their initial caps. I know you highlighted changes to the ICA fee rates recently. How should we think about the new caps on those 2 items as well?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Sure. So I think, on the 25% to 50% beta, I think, that's still our view. I mean, I think, when you look at the 6 hikes we've had in this cycle, I think its probably played out as one would expect, right? The first few hikes folks really -- most folks didn't move as you were coming off the bottom. And then over the last 3 hikes, I think, you've seen people start to move up. So this most recent hike for us, the 25%, I think, that made sense to us. And I don't think we have any different view on the 25% to 50% and we really haven't seen any change in behavior. So I think, we feel confident about that. But also I just emphasized that's why it's a range, right? It's a range of 25% to 50%. On the money market, I think the rates on money markets, really the caps haven't changed. That's more about the mix of balances in those different accounts, right? Different accounts have different caps, so it ends up being a weighted average number. That's the only thing that would impact there. And then, DCA. So DCAs are, as a reminder, I'm sure you know, is a fee per account, it's not basis points on the balances themselves. So that rate can move around. The fee per account cap hasn't changed. We effectively hit it with this last rate hike. So going forward, the economics there are going to be more about the number of accounts based on that fee. So I think that covers the 3 questions, right?

Steven Joseph Chubak - *Nomura Securities Co. Ltd., Research Division - VP*

You caught me there with a bunch of nested questions within. But I'm going to ask my follow-up here, I'm going to leave it to just one. But you spoke of your capital management priorities, including M&A. I'm just wondering given your experience with NPH, the higher accretion target is certainly encouraging. How did that inform your appetite? And then just related to that, how should we think about, given some of the favorable tailwinds, both markets and rates, informed potential willingness of acquisition targets to sell at the 6 to 8x EBITDA you've cited in the past?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes. So I'll go first and, Dan, obviously jump in. I think, when we think about the M&A, our thoughts on the M&A environment haven't changed. I would tell you as a high-level point, the NPH acquisition, I think just validated our view that when you look at our space, it's right for consolidation. And if we can do something that's a match to us both financially, operationally and strategically, if all those things line up, I think, we would be interested. So I don't know, Dan, if you'd add anything to that?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

No. I think that's well said. And as you see, we from a readiness standpoint, I think we always got to be thoughtful about are we ready from a financial standpoint. And operationally, we think the balance sheet is well positioned for us to be nimble and agile relative to a potential opportunity of most any size. I think from an operational standpoint, we still think about making sure that when we start integration work, that we're in a good place to do that well and we still think more towards the end of the year as being a relevant time frame for readiness there.

Operator

Our next question comes from Bill Katz of Citigroup.

William R. Katz - *Citigroup Inc, Research Division - MD*

Just sort of coming back to (inaudible) down after a good quarter as well. But if I look at the financial adviser account stripping out the onboarding of NPH and also look at what looks like to be a flattish month in March, how do you think about organic growth away from the transaction? And what would be the catalyst to get both of those items going?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes, Bill, so a couple of things. This is Dan. So let me take a stab at that first and, Matt, you certainly add any color to this. With respect to the adviser account NPH, it was down 84 for the quarter. That was primarily due to a large number of low producing advisers who did not renew their licenses and many exited the industry. From a timing that typically occurs some time in the December to January time frame, this year we saw more of that occur in January than we did in December. So that's creating some noise, if you will, with respect to adviser account in the quarter. Of course, the other things that impacted the adviser account is our standard retention, which was in the 96% range of prior year production and then we recruited $4 billion of assets. Both of which are important parts of our formula for organic growth. I think if you look at the NNA for the quarter, that was roughly $3 billion, which was primarily driven by advisory flows. There were $4 billion of brokerage outflows for the quarter. And I think you saw a good bit of noise in the brokerage outflows in March. You also had a bit of lumpiness in March relative to attrition. And again, I think if you look at it over the full quarter, as we said, it was 96%, but a bit of lumpiness in March. So that had some noise, if you will, with respect to just that particular month. With respect to growth overall and our focus, right, we are very much focused on our core growth and our core markets and that comes from us focused on adding new advisers, certainly helping and supporting our existing advisers grow and then retaining what we have. And so, that hasn't changed and we think that you've seen building momentum over the past few quarters and we feel good as we go forward about using that same formula to drive growth in our core markets.

William R. Katz - *Citigroup Inc, Research Division - MD*

Okay, that's helpful. And then just a follow-up. As you -- there's been a lot of discussion on just sort of the economic outlook for the hybrid platform in general, whether it would be the [OBA] which I think you sort of helped address or as well as I think a sizable RIA that was looking to potentially move out on its own. So could you maybe step back and help us understand the structural drivers for hybrid. And then the sort of second part of that question also sorry for asking this question, how do we think about the gross profit ROA given the sort of the shift in the recruiting dynamic as well as some of the pricing changes?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes. So there is a lot there. So if I don't get it all, I'll do my best and please you can, I guess reiterate on the question. But look, there is a -- we have a great belief in the opportunity to continue to grow advisory assets. It roughly represents 70% of new flows coming in to the business to date. And we think that having both our hybrid RIA and our corporate platforms are really important. They broaden the versatility and the appeal, if you will, of more client -- more advisers to our platforms. And so we think that's a good thing from a strategic and a positioning standpoint of which the cash that broaden that, it gives our advisers lots of flexibility as to how they may choose to use us and leverage the capabilities of our platforms.

So we will continue to invest in both to ensure that they create an opportunity to help advisers differentiate and win across both platforms. I think what you see us trying to do is make both of those platforms more appealing. In the last couple of years, we've made significant investments in the corporate RIA to bring down its cost to add capabilities and investment content to it. And I think this has worked well both in terms of giving advisers the capabilities they need, but coupled with also the rising sort of complexity of the regulatory environment, not having to take on the regulated entities themselves and leveraging that corporate RIA at a lower price or a lower cost has been a good trade for them. So we will continue to make those same investments to make that solution more appealing. At the same time, there are advisers who have larger practices and feel like that hybrid RIA platform gives them the either needed flexibility or the better economics of which to manage their practice. We recognize that, that will be right for a certain set of advisers. And so, we've tried to build the platform such that we can provide the appeal and flexibility to those type of advisers. And so strategically that thinking is what is driving our approach to both those offerings and how we may engage and think about serving and supporting clients. I think to your second question, which was built around how do we think about serving these larger enterprise clients or these bigger clients, I think, that we continue to see them as a great opportunity, a great partner. We don't see any specific concern over another large enterprise. We made the policy change that we did last year that helped strengthen our overall alignment with these large enterprises. And they've been good partners at helping us work through those changes. And now we're committed to helping them grow just like any other practice. And again, in that spirit, we'll invest in both corporate and hybrid platforms to help them win. So I hope that answered that broad question.

Operator

Our next question comes from Conor Fitzgerald of Goldman Sachs.

Conor Burke Fitzgerald - *Goldman Sachs Group Inc., Research Division - VP*

Dan, appreciate your comments on increasing transition assistance to try and attract more advisers in the near term. So maybe just 2 questions on that. Any sense of how impactful you think this could be on increasing your net new asset rate? And then, if you like the financial characteristics of the offering in terms of the trade-off for higher transition assistance versus growth, why not make it more permanent? Is there something you're seeing in the market that's maybe making you more trying to do this now?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes, good question, Conor. So our principle here is to use our strength in a more agile way, right. So we're experimenting with different strategies that we believe will be effective in the current environment. And so this quarter, we were really focused on exploring simplifying our message, leveraging our balance sheet, as we mentioned, and then, reducing complexity for advisers in motion. And our sales cycle is a bit longer. So it's too early to assess the effectiveness of it. But as we progress, I think, that's exactly what we'll do. We'll assess the outcomes of this effort, this initiative. And to the extent that it's successful and we get a more informed view as to the outcome, so I think then we would think about pivoting our strategy longer term based on that insight and that learning. So think about it as an iterative process, if you will. I don't know, Matt, do you want to add anything else to that?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Sure. I mean I would just emphasize that from a financial discipline perspective, Conor, I mean we are focused on deploying capital where it drives the best returns. We think that's organic growth. And one of the biggest buckets of opportunities to do that on organic growth is transition assistance. And we come at this from a -- with financial discipline of just underwriting and a return that we think is quite compelling. So I think to build on Dan's point, if we continue to see this as compelling, and I think we'll make that judgment call at that time whether that makes sense to keep going.

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Hopefully that answers your question, Conor.

Conor Burke Fitzgerald - *Goldman Sachs Group Inc., Research Division - VP*

It does. And then Matt, maybe one for you. I know you've talked about one of the reasons why most of your ICA contracts are tied to short-term rates is that's the preference for most of the banks. So just want to get an update on any of that, if any of that is changing or things are starting to potentially be willing to enter into more longer duration contracts? And just, your updated thoughts on how you're thinking about positioning the balance sheet and the interest rate sensitivity of the company as short-term rates continue to normalize here?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes. So I think, where we are today, it hasn't changed much, right. I think the -- when you look at the different types of interest rates that our balances are tied to, fed funds is the largest and the others are still on the short end of the curve so one must (inaudible) more with a little bit effect. So that hasn't really changed. I think when I just think about our long-term perspective, I think, we're going to be cognizant of where we are in the rate cycle. And to state the obvious, when you're at 0 or near 0 rates, there's very little risk to the downside. And if you pick a number, whatever number you think terminal fed funds is, if you're out at that level, the risk to the downside is much higher. So I think, we recognize that. And I think our view

-- we'll ultimately have a view on where we would prefer to be, and then you just have to match that up to what the market's willing to provide. So I think, that's our long-term view. Where we are right now is we continue to be positioned on the short end of the curve, and that's where we like to be.

Operator

Our next question comes from Doug Mewhirter of SunTrust.

Douglas Robert Mewhirter - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

I had one sort of almost a trivial question but it's been kind of bugging me and the other one's more a broad strategic question. First, the trivial question, I noticed you've been running at about $10 million a quarter of other revenues and it was only about $0.5 million this quarter. And I just want to make sure whether that was just flat out noise or whether you had recast a portion of this other revenues into another category? And if it is just noise, will we expect a rebound in that line?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Doug, it's Matt. Are you referring to interest income in other, that row?

Douglas Robert Mewhirter - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Just the -- it's the other line, $593,000 in your income statement. Interest income, net of interest expense was $7.8 million.

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes. We follow them. What page are you on? I'm not sure what number you're looking at.

Douglas Robert Mewhirter - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

We can follow up later. It's not a huge issue.

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Oh, you're in the -- I got you. No, there's nothing going -- that line item is where -- I'm sorry, looking at the management P&L on Slide 9. So on Page 6, so that's where the mark-to-market shows up on the adviser deferred comp. So you see that move around a lot. We net that number together with the interest income, net of interest expense above it on the management P&L. So that number is offset typically in the payout. So I'd just encourage you to look at the slide or Page 9 view, where that noise gets netted out in gross profit. So there's nothing to be concerned about there.

Douglas Robert Mewhirter - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

That's very helpful. And Dan, with the new SEC rule or the SEC proposal, I should say, has that -- is that affecting how you're doing product development? I know you'd been very encouraged by the progress in your mutual fund only platform, which you had taken a lot of time to build? I didn't know whether you would make an adjustment midstream, you would stay the course with that or you would maybe look to build some sort of alternative which may fit the SEC rule better? Or do you think it's just a good product in any kind of compliance environment?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes. Good question, and I think our principle around mutual fund only solution, which we think is a really creative solution and it has lots of appeal to it, we still believe that. And what we were doing was trying to time that relative to the regulatory change. And hence, as the date moved around, we would tend to alter and adjust the rollout plans associated with it, certainly with the DOL rule likely being vacated and now the SEC taking up the rule-making process. Again, we're on pause to try to figure out and get better clarity of the SEC's rule itself and then, ultimately, the timing of it. That will then allow us to then better understand how to pivot relative to any adjustments in the products in that product or in that product development, we would need to make or how or if we would use the solution. So it's a bit of a wait and see to get more information and insight around the rule itself before we can make those determinations.

Operator

Our next question comes from Ann Dai of KBW.

Yian Dai - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP of Equity Research*

Maybe a question for Dan. So I just wanted to kind of go back and reflect on NPH now that we're mostly closed and you've got some more meaningful perspective on the adviser feedback from that transaction. I'm just wondering if you could give us some of the pros and cons or maybe a lesson learned from the deal and what you take away from that for future deals?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes, so maybe at a high level, I think, as we think about the deal, we went into it as an opportunity, of course, to learn with the thoughtfulness of building some acumen that we could then use on a go-forward basis. So that was our premise going in. As we reflect back on it, I think, that ultimately the deal structure and valuation certainly ended up proving to be a solid one. When we looked back over our recruiting strategy associated with that deal, I think, we learned some things and some lessons relative to the value of simplicity and speed with respect to those recruiting efforts. We tried to approach the onboarding and integration of those advisers in a very different way than we had ever had before with any transaction, making sure we had enough resources both to innovate as well as to add incremental human capital to support that integration and onboarding process. And I think we got some things, interesting things right with respect to innovation. We've got some good lessons learned around data and, quite frankly, the conversion of direct assets. So those may be some places where we think about ever in the situation in the future of an M&A opportunity, where we may tweak or iterate on our approach to improve and enhance both our retention rates as well as the quality of the onboarding experience.

Yian Dai - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP of Equity Research*

Okay, that's very helpful color. I appreciate that. My follow up is just on a couple of ratios. So first on the base payout ratio. It looks like that was roughly flat quarter-over-quarter. And I think just with the price decrease in the SAM portfolio, I would have expected that to come up a bit. So was there anything specific to NPH assets coming onboard or something else that impacted that? And then same on corporate. It felt like corporate adviser fee rates ticked up a little, so anything specific there as well?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Sure, Ann. This is Matt. So on the SAM pricing increase, that actually shows up in the production base bonuses rate. So if you look in the release, that's why that year-over-year was up 33 basis points was almost entirely for that pricing increase showing up there. On the corporate side, it's really mix and primarily the growth we've seen in the centrally managed platforms. The fees for that show up in that line item. So it's really a mix and really the success and growth Centrally managed that drove that second increase.

Operator

Our next question comes from Devin Ryan of JMP Securities.

Devin Patrick Ryan - *JMP Securities LLC, Research Division - MD and Senior Research Analyst*

Maybe just a follow-up here on the SEC best interest. I appreciate some of the comments that you made. And it seems like the industry is pretty supportive and the devil will still be in the details. But what other considerations should we be thinking about from the I don't know if it's higher cost or any changes in relationships with third-party manufacturers? And then maybe on the other side of that, are there opportunities like for example, if RIAs were held to higher licensing standards or continuing education maybe that reduces some of the appeal being kind of a pure RIA which maybe would be good for you guys? So just trying to think about some of the considerations there?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes. So Devin, I think that it's a little hard because it's early in the process, right. We do think having the SEC work on this and creating consistency across both qualified and nonqualified is smart. It's helpful both in terms of how the adviser would work and manage their clients and I think it's helpful for the overall industry and how we supervise and manage that business. So I think, that is a positive thing, basically all the way through the ecosystem, right. Certainly, the way that this rule would potentially be enforced is we think much more reasonable and aligned with historically how we've provided or held accountable the compliance with regulations. So we like that pivot in that shift, which we think is a good thing.

With respect to the utilization or the mix between brokerage and advisory, I think, we believe in the preservation of choice. We think the approach that the SEC is taking has a great respect for providing and maintaining that choice which again we think is a really good thing for clients, and we think it's a good thing for advisers. And we will continue to make sure that we ensure that our advisers can provide that choice. And I think that would be reasonable then to assume that this mix between advisory and brokerage would continue. It's hard to predict exactly what that exact mix would be. But I think it's reasonable to believe that those duly registered advisers, that would be an appealing option to have to be duly registered, and that they would continue to use both types of solutions.

I think with respect to the utilization of advisory going forward, we see that as a big place of innovation and a place to continue to expand how we serve and support advisers needs there, such that to the extent that you can create great value for those advisers to deliver to their clients across, whether that be advisory or brokerage, we think is ultimately the key driver of what we do and then certainly, we can use the regulatory environment as a way to ensure both that we comply, but also that we take those capabilities, and we are able to use them in a differentiated and appealing way.

Devin Patrick Ryan - *JMP Securities LLC, Research Division - MD and Senior Research Analyst*

Got it. Great. And maybe just a quick follow-up. Appreciate the detail on the outside business activity asset. I guess, the $2 million, can you remind us what that number is? And just want to make sure there's no other kind of administrative fees connected to that.

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes, I think, the question around the rule itself would be that if broker-dealers didn't have to provide oversight of the outside business activity associated with their advisory business, that -- the oversight that we provide to off-platform assets and the fee that we charge for that would be eliminated. That's the premise of this. And so, as you know, we have a small amount of advisory assets. They're held off platform in our hybrid RIAs, and that's where we were referencing roughly $10 billion. That does not show up in our asset count, obviously. And so we roughly charge $2 million a year associated with those assets. So that's the $2 million in revenue that would go away assuming that we end up in a place where the rule ultimately goes through. We think there will be a lot of dialogue and a lot of discussion and debate around the merits of this rule. And whether or not that will occur, which we'll typically create an extended time line of which we think this dialogue and debate will go on, we're supportive of the premise of the rule and believe that our capabilities around our advisory platforms, both the hybrid and the corporate and our custodial capabilities create a sort of an advantageous set of capabilities that we believe we can use to differentiate regardless of the outcome.

Operator

Our next question comes from Craig Siegenthaler of Crédit Suisse.

Jordan Friedlander

This is Jordan Friedlander filling in for Craig Siegenthaler. Just a quick one for me here. Given the rising rate backdrop as well as the DOL rule being vacated, could we see a continued pickup in variable annuity sales?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes. It's a good question. And I think when we think about the overall commissions, right, Matt referenced some growth in our overall commissions, both sequentially and year-over-year, much of that was driven by NPH, but when you peel that back, we've seen sequential growth ex NPH for the past 2 quarters in commissions. You look at first quarter, that was primarily driven by mutual funds, which we think is indication of increasing use of active management. As we look forward, I think that we do believe that there could be some momentum building around variable annuities for 2 reasons. The more volatility you see in the marketplace, the more downside protection benefits that a variable annuities offer are more appealing. And then I think the second thing is as you say with higher interest rate environment, typically, there's a correlation between product innovation in that VA space and with product innovation with more appealing downside protection and capabilities and benefits, that's logical to think that, that could create some momentum in variable annuity sales.

Operator

Our next question comes from Chris Shutler of William Blair.

Christopher Charles Shutler - *William Blair & Company L.L.C., Research Division - Research Analyst*

On the transition assistance offered to NPH Advisors, $31 million was cash, $66 million forgivable loans. I think I heard you say, Matt, that NPH is going to drive about $7 million a quarter of higher amortization. So does that mean the average vesting period is 2.5 years roughly for NPH on the forgivable loans. And why -- if so, why is it so short?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes. So there is a little bit of noise and I'd say it's more in the -- a little bit longer than that, in the 3 zone. And I think the transition assistance, the amount of time is really on an adviser by adviser basis. I think it is just reflective of how that dialogue went. But it is a little bit longer than that, more in the 3 year range.

Christopher Charles Shutler - *William Blair & Company L.L.C., Research Division - Research Analyst*

Okay. Fair enough. And then, Matt, on the ICA, maybe you talked about some of that being based on 1, 3-month LIBOR. With the changes that we've seen in LIBOR rates over the last couple of quarters, I guess, how much incremental benefit could you realize if you shifted more assets to be based on LIBOR? Is that a possibility? Going from 152 to mid-160 just seems maybe a little less than you'd expect given the move in LIBOR?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes. So I think, the key on that guidance was assuming no additional benefits from interest rates or changes to our deposit rates. So we're not going to -- we're not trying to forecast or predict where interest rates go. I think to state the obvious, if fed funds goes up and if LIBOR goes up, that rate would go up. But I think, that's just reflective of getting the full benefit of the rate hike that we just had. It's just, Chris, it would be hard to predict where the curves go and what incremental benefit we could get.

Christopher Charles Shutler - *William Blair & Company L.L.C., Research Division - Research Analyst*

So you're just using LIBOR from the first quarter basically?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

No. I would just take the mid-160 to say assuming no incremental benefits other than the hike that we saw, that is what we would expect. So if you see -- if you assume another hike or you are assuming some benefits from LIBOR, then it would be above that.

Operator

Our next question comes from Chris Harris of Wells Fargo.

Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

This topic was alluded to earlier, but I don't think we really got into the specifics and that relates to press reports tied to the potential departure of independent financial partners from LPL. So I just want to give you guys a comment to maybe talk about whether those press reports were accurate? And then, for us, how should we be thinking about the financial impact to you guys from that departure?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes. So let me start with that and then Matt -- I'll turn it over to Matt for the financial color on it. So the press reports are accurate in terms of IFP was a unique situation where we were not strategically aligned with them. Consequently, we mutually decided to part ways. They are starting their own broker-dealer that will likely take a full year to set up. In the meantime, we're working with their advisers to help them understand their choices associated with affiliation. And we believe we have a compelling offer to stay with LPL. So we'll see how that plays out over the next 12 months. And I think Matt, you may want to give some color on financials.

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes, sure. So they have about $12 billion in AUM with us, roughly evenly split between brokerage and advisory. The return on those assets are below the average return that we have, just to give a little directional input there. And I just how to think about it, I just emphasize what Dan just closed with, that we believe we've got a really compelling offer to stay at LPL and we'll just see how that plays out over time.

Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

And what's the timing guys? Do you have a sense of the timing of when the departure might occur?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

It is hard to be exact because they are creating their broker-dealers. So we've agreed to have them stay on our platform as they make the preparations to do that. That's why we said directionally, it will take 12 months. That's not meant to be exact, but I think, that's a fair sort of directional way to think about it.

Operator

Our next question comes from Michael Cyprys of Morgan Stanley.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

Just curious if you could talk a little bit about the competitive environment today for recruiting new advisers? How that has evolved over the past 6 to 12 months? Do you see fewer or more advisers moving today? And who do you see yourselves competing with most out there in the marketplace today for those advisers?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes. So I think, if you go back to the traditional source of our recruits, I'll answer that part of it first. We continue to see opportunity to recruit both from independents or sorry advisers that are independent that may be looking to make a change or look for a broker-dealer that may have more capabilities or are larger scale and stability. So that continues to be a source of opportunity for us. We also have the opportunity of recruiting those advisers that may be leaving an employee based model or warehouse and looking to go independent. So we still leverage that structural trend. And of course, on our institution side of the house, we continue to see banks and credit unions who are either exploring getting into this business, which is a much smaller percentage or those that are again maybe looking for a broker-dealer with a bit more capabilities. So those still continue to be good sources of opportunities for us, and we focus across the board on them. I think, with respect to the overall recruiting environment, when we came into first quarter, we had still a bit of a headwind from our focus on NPH. And I think, we've seen good steady building of momentum throughout the quarter. And we certainly see people who are out in the marketplace, exploring their options and alternatives. But we still see that our model resonates. And when you look at the combination of value and capabilities with the price associated with it, that tends to be an appealing scenario. I do believe that typically you run into a bit less adviser movement in first quarter as it's tax season and people tend to focus on -- advisers tend to focus on a lot of servicing of their IRAs in qualified accounts in first quarter. The second thing that occurs is typically when there is volatility in the market, you get a little less movement as well as people are focused on serving and supporting those clients or a little less flexibility in making a strategic pivot in their practice. So hopefully that gives you a little color. But we continue to summarize. We continue to see opportunity across those 3 traditional markets we recruit in. We're typically seeing the same competition that is out there and we are still seeing appeal associated with our model.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

Great. Thanks for the color. And just as a quick follow-up on the net new on the adviser side of the business, net new adviser assets coming in at the door, can you just give us a sense of how much is coming from increased wallet share amongst the existing customer base versus net new assets coming from new customers of your advisers?

Matthew Audette - *LPL Financial Holdings Inc. - MD & CFO*

Yes, sure. I mean, I think directionally, and we think about as what we call same-store new store. From a same-store standpoint, I'd say that was call it 2/3 this quarter was the driver from that.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

And does that change much over the past 12 months or so, 2/3 same-store?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes. I think that we continue to invest in both the capabilities we have to support and help our advisers growth. And we've seen that same-store number build over the past year and make a bigger contribution to that overall net new assets than perhaps it traditionally or it historically has. And so we're encouraged with that trend. I think if I was going to give you a directional trend around it, perhaps, it would be more like 1/2 to 2/3, just building on Matt's comment. That gives you a sense of the order of magnitude that I'm talking about.

Operator

Our next question comes from Ken Worthington from JPMorgan.

Kenneth Brooks Worthington - *JP Morgan Chase & Co, Research Division - MD*

In terms of legal, we saw some legal headlines this quarter on some legacy issues, Dan, I think you mentioned one. I'm curious to what extent you are seeing an uptick in legal engagement on more current issues. So I guess, first, have you seen any legal action as the broker protocol unwinds? And two, given the volatility in the market, there is definitely losses on things like fix and crypto currencies. Are you seeing more legal either increase or engagement here either?

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Yes. So let me answer specifically and I'll walk back up to maybe the initial question asked which is a bit more macro. So specifically with respect to protocol issues, we are not. We recruit from both protocol and non-protocol firms. We historically have done that. So we kind of understand that process. So we've seen nothing pick up there. We are not allowing crypto currency trading within our ecosystem. So we are seeing nothing there associated with that more speculative investment. On a macro level, I think that we have not seen any outsize or step function change in overall concerns, risks or challenges associated with our overall macro business from a risk standpoint. As a regulated entity, there is always things that come up from time to time, but nothing that has been either outsized or out of the ordinary relative to more current activity as you asked.

Operator

And this does conclude our question-and-answer session. I would now like to turn the call back over to Mr. Arnold for any closing remarks.

Dan Arnold - *LPL Financial Holdings Inc. - President, CEO & Director*

Thanks, Sonia. And I just wanted to thank everyone for taking the time to join us this afternoon. We appreciate it, and we look forward to speaking with you again next quarter. Thanks so much.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone, have a great day.
