LPL FINANCIAL HOLDINGS INC.

(Ticker: LPLA)

GREEN LIGHT | **YELLOW LIGHT** | RED LIGHT

LBIR Recommendation

Stock Price: $245.0 (10/25/2022)	Company Size: $19.5B	Author: Madhu Chaudhary
Company Rank: -	Sector: Financials	Industry: Capital Markets

LPL Financial is one of the largest independent broker-dealer in the US, with over $1T in Assets Under Management (AUM).

IN THIS FIRST FOCUS WE'LL COVER:

- **Summary of the Business**
  LPLA is a leading broker dealer firm catering to front, middle and back office needs of independent financial advisors, financial institutions, and Registered Investment Advisors (RIAs).
- **Recent Developments**
  LPLA's top line was positively impacted by rising rates and addition of new assets through organic and inorganic investments. Profit margins expanded due to higher operational efficiencies and business scale.
- **Competitive Environment**
  The company directly competes with some of the well know independent broker-dealer firms such as Raymond James, Royal Alliance, Commonwealth, Cambridge, etc.
- **Conclusions/Recommendations**
  LPLA is well placed to benefit from further rate hikes by Fed via greater advisory fees and wider spreads. That being said, the stock is hovering near all time highs and all near to medium-term opportunities appears to be already priced in. We assign a **"YELLOW LIGHT"** rating to LPL Financial Holdings, Inc. (LPLA).

Grab-and-Go™ THESIS

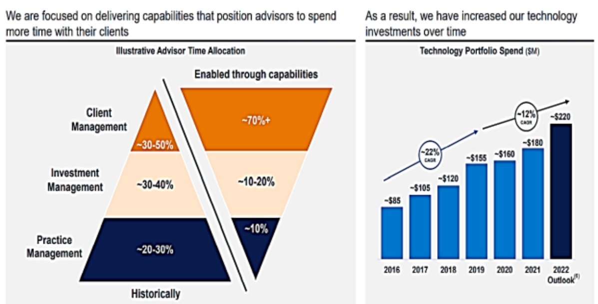
An investment in LPLA is a play on growing demand for advisor mediated investment advisory services in the US. The company has grown to become one of the largest independent broker-dealer firms in the US through organic and inorganic investments. Its success will depend on its ability to diversify its service mix further which will drive advisor and eventually asset stickiness to the company's platform.

Data as of 10/25/22 unless specified

Enterprise Value:	$21.6B	Market Cap:	$19.5B	Revenue Fwd (TTM):	$8.5B ($8.2B)
YTD Return:	52.5%	Fwd (TTM) Price/Sales:	2.2x (2.3x)	RSI:	54.2
Non-GAAP Gross Margin (TTM):	32.3%	Revenue Growth (TTM, YoY):	23.6%	ROIC (TTM):	13.1%
52-Week High:	$252.2	52-Week Low	$140.7	200-day Moving Avg.	$196.4
Non-GAAP Net Income (TTM)	$505.4M	CFO	$509.4M	FCF	$228.6M
Insider Transactions (2022): Dan H. Arnold (President & CEO) sold 4.4M shares, Matthew J. Audette (CFO) sold 132K shares, and Michelle Oroschakoff (MD) sold 662K shares.					

SUMMARY OF BUSINESS

LPL Financial was founded in 1989 to leverage the rising demand for advisor-mediated investment advisory post the October 1987 stock market crash. The company was formed as a result of a merger between Private Ledger and Linsco, two of the leading broker-dealer firms at that time. Since its founding, LPLA has grown both organically and inorganically to become one of the largest independent broker-dealer firms in the US. The company offers a suite of solutions to a variety of clients including independent financial advisors, Registered Investment Advisors (RIAs) firms, and large financial institutions. Its offerings include an integrated cloud-based technology platform that helps advisors add new clients and keep track of them, open accounts, document imaging, transaction executions, and various back-office applications. Additionally, it also offers comprehensive clearing and compliance services, practice management programs and training, business solutions and planning advice, and in-house research. In simple terms, the company helps advisors with their end-to-end investment advisory-related services and grow their business without having them worry about all the front, middle, and back-office work. The company holds over $1T in client assets and has nearly 21,000 advisors consisting of more than 11,700 independent advisors, over 5,600 independent RIAs, and more than 3,400 institutional services actively using its platform. The picture below shows how the company's increased investment in technology has positioned advisors to invest more time in client management and leave investment and practice management on the company's shoulders.



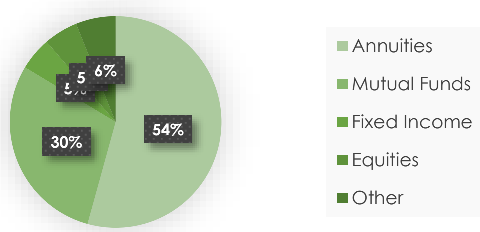
Source: Investors Presentation – Q2 2022

The company's revenue stems from diverse sources as explained below:

Advisory: The company helps advisors make investment-related decisions and execution on behalf of their clients under this service segment. It offers brokerage and execution services on the transactions, provide investment advice and acts as a custodian, and performs other administrative operations for advisors. The company charges the advisors a percentage of the market value of the assets under their advisory accounts. Advisory services accounted for 48% of the total top-line excluding unrealized gains and losses and other miscellaneous revenue in Q2 2022. The company had $559B in advisory assets under management in Q2 2022, representing 53% of the total advisory and brokerage assets.

Commission: The company also derives 27% of total revenue from commissions stemming from trading and purchasing of investment products from the clients. The company had $506B in brokerage assets in Q2 2022 through which it generates commissions. The pie chart below shows commission revenue by product.

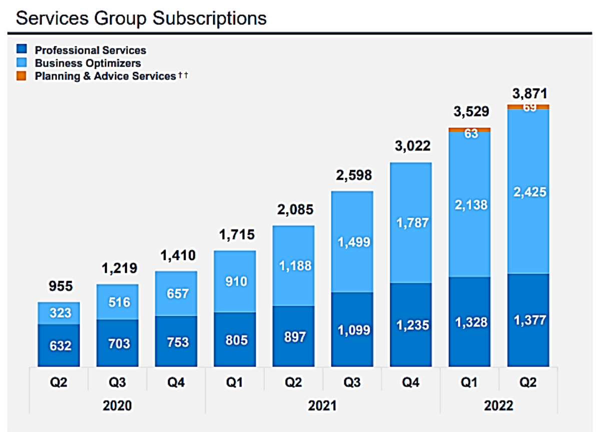
Commission Revenue By Product - Q2 2022



Source: Company's Press Release – Q2 2022

Asset-Based: The company also receives a fee from the client's cash programs, sponsorship programs with financial product manufacturers, and omnibus processing and networking services. It recorded a total client cash balance of $70B in Q2 2022, translating into 7% of total assets. Asset-based fees contributed 17% to total revenue in Q2 2022.

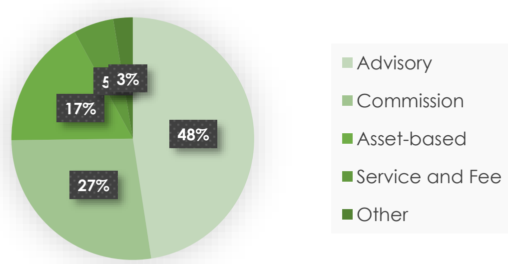
Service and Fee: The company also generates recurring revenue in the form of service and fee for providing technology, insurance, licensing, business services and planning and advice services, etc. to advisors. Its service group subscriptions consisting of professional, business and optimizers, and planning and advice services have grown 86% YoY from 2,085 in Q2 2021 to 3,871 in Q2 2022, generating an annualized revenue of $32M. Service and Fee contributed 5% of total revenue in Q2 2022.



Source: Investors Presentation – Q2 2022

Other: The company also derives revenue from interest income from client margin loans and advisor loans. Interest income and revenue from other sources such as transactions accounted for 3% of total revenue in Q2 2022.

Revenue Mix - Q2 2022

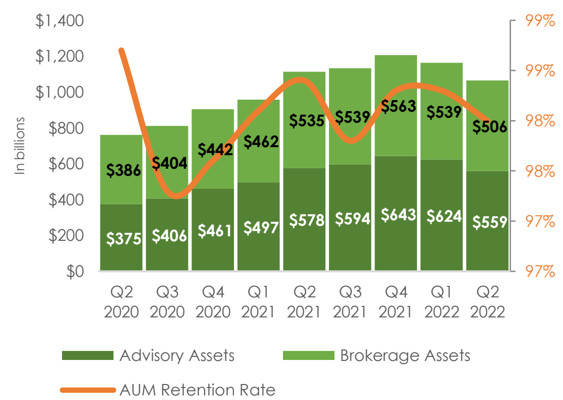


Source: Company's Press Release – Q2 2022

LB•LOGIC We like the fact that the company derives revenue from diverse sources thus minimizing the revenue concentration risk. Additionally, material portion of the company's top-line is dependent on fees as a percentage of AUM and recurring service fees which bring predictability and stability to revenue.

Consistently growing via organic and inorganic means, LPLA has built a strong advisor and client base consisting of 20,871 total advisors and 7.6M of total clients as of Q2 2022. This has led it to manage over $1T in total assets comprising of advisory and brokerage assets thus making it one of the largest independent broker-dealers in the US. Acquisitions and partnerships have played a key part in increasing the company's total Assets Under Management (AUM). In 2021, the company acquired the wealth management business of Waddell & Reed Financial, Inc. for $300M leading to the inclusion of $74B in client AUM. LPLA also acts as a leading third-party provider of investment advisory-related services to large financial institutions. In Q2 2022, the company onboarded the wealth management business of CUNA Mutual Group which brought over $36B in total assets and more than 550 advisors on the company's platform. It is expecting to onboard the wealth management business of People's United in 2H 2022 which is forecasted to bring over $6B in total assets and more than 30 advisors on the company's platform. In addition to robust growth in the company's AUM, the AUM retention rate has also remained solid averaging 98% over the past four quarters signifying a sticky asset base.

Total AUM and Retention Rate Trend



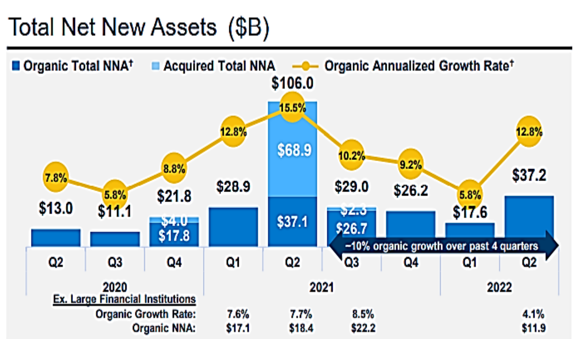
Source: Investors Presentations

RECENT DEVELOPMENTS

LPLA being the independent broker-dealer is to a large extent immune to the rate movement. When the interest rates are low and the economy is expanding, the company benefits from robust equity markets as more clients turn to advisors for allocating their income to high-yielding assets such as stocks. The company meanwhile generates higher advisory fees and commissions due to a sized asset base and frequent transactions. During a rising rate environment, the company not only leverages higher administration and recordkeeping fees for cash balances in the client accounts but also enjoys a wider spread i.e., the difference between the yield earned by LPLA on cash balances lent out to third-party banks and other financial institutions and the yield paid to the clients. The recent rate hikes by the Fed to curb inflation helped the company to enjoy higher cash sweep balances and transaction volumes evolving from additional portfolio rebalancing activities by the advisors.

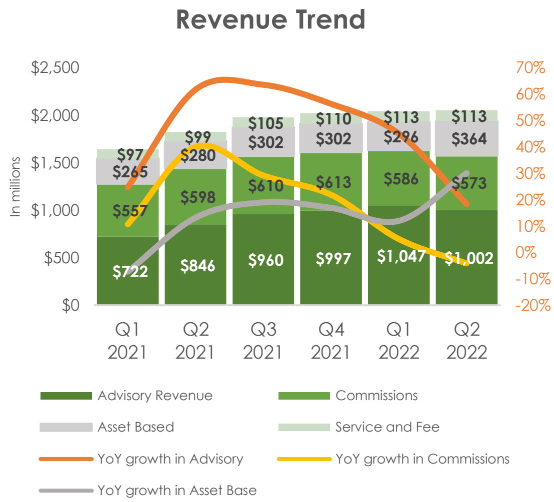
> **LB•LOGIC** Each 1% increase in market level (S&P 500) positively impacts the company's gross profit by about $10M. Additionally, every subsequent 25-bps hike in interest rate could provide the company up to $80M of incremental gross profit. This signifies business model's natural hedge to market volatility.

The company reported $2B in total revenue in [Q2 2022]() as compared to $1.9B in Q2 2021, translating into a YoY growth of 7%. The revenue from advisory fees grew 18% YoY from $846M in Q2 2021 to $1B in Q2 2022 driven by increased billable advisory assets from organic and recruiting efforts partially offset by a decline in total advisory assets due to lower equity markets. The company has averaged 10% organic growth in total net new assets reflecting that the existing advisors are finding company's platform valuable and are increasing their AUM.



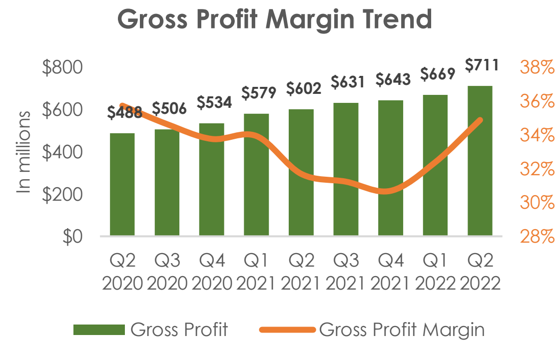
Source: [Investors Presentation – Key Metrics]()

Asset-based revenue rose 30% YoY from $280M in Q2 2021 to $364M in Q2 2022 as a result of increased client cash revenue. The revenue from service and fee also jumped 13% YoY from $100M in Q2 2021 to $113M in Q2 2022 due to increase in subscriptions of LPL Services Group Solutions.



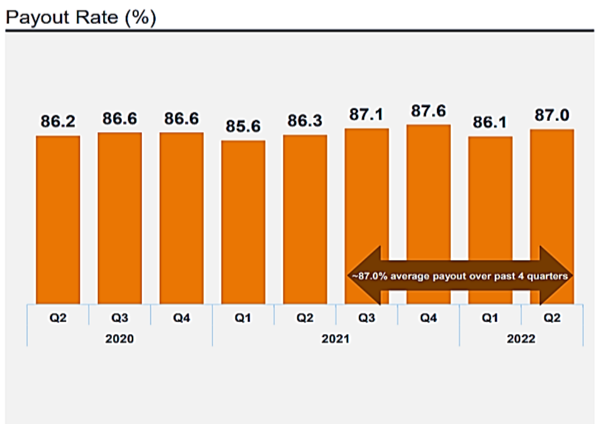
Source: Company's Press Releases

Gross profit, calculated as revenue minus advisory and commission expense and brokerage, and clearing and exchange expense rose 18% YoY from $602M in Q2 2021 to $711M in [Q2 2022](). On a margin basis, gross profit margin expanded 320 bps YoY to 35% driven by top-line leverage.



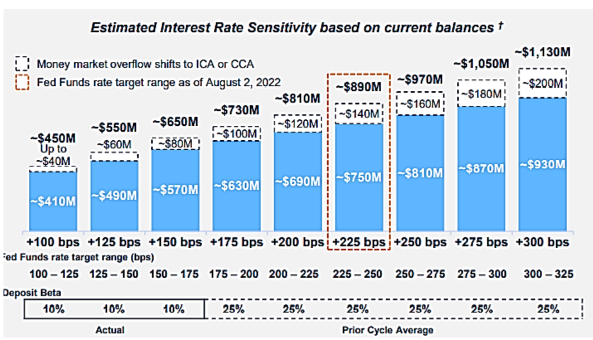
Source: Company's Press Releases

Interestingly, margin expansion has been achieved on the back of a solid payout rate (calculated by dividing production-based payout by total advisory and commission revenue) that averaged 87% based on the last four quarters. This signifies the benefits of economies of scale that the company leverages due to a materially large asset base.



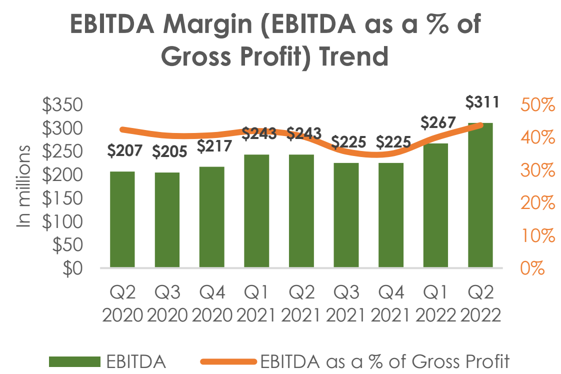
Source: [Investors Presentation – Key Metrics]()

The management is expecting gross profit to benefit from the rising rates as advisors on behalf of their clients look to allocate more capital to cash and earn interest amidst a volatile macro backdrop. Based on historical trends and internal estimates, the company projects about $80M in incremental gross profit for each subsequent 25 bps rate hike. With Fed raising the rate by 75 bps at September 2022 meeting and announcing the new target range between 3% to 3.25%, the management forecasts gross profit to reach well above the $1B mark as shown below.



Source: [Investors Presentation – Key Metrics]()

Growth in the company's revenue and gross profit trickled down to its operating margin. The company reported $311M in EBITDA in [Q2 2022]() as compared to $243M in Q2 2021. EBITDA margin (EBITDA as a % of gross profit) also expanded 320 bps YoY to 44% in Q2 2022. EPS prior to intangibles and acquisition costs also rose 21% YoY to $2.24 in Q2 2022 as a result of organic growth, rising rates, higher client cash balance, and operational efficiencies.

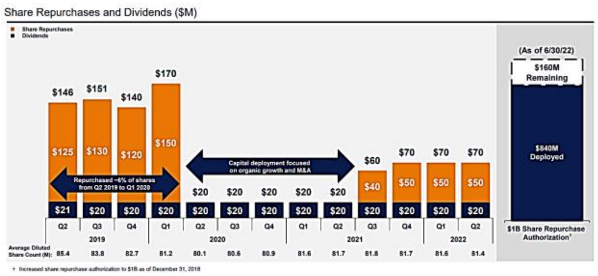


Source: Company's Press Releases

The company holds a robust balance sheet comprising of $241M in corporate cash and $2.7B in total debt as of Q2 2022. Its leverage ratio i.e., net debt to EBITDA stood at 2.09x and remained within the management range of 2x to 2.75x. It generated $509M in Cash Flow from Operations (CFOs) and $229M in Free Cash Flows (FCFs) on a TTM basis thus positioning it well to continue creating shareholders' wealth through buybacks and dividend payments coupled with growth investments. The company repurchased $50M worth of shares and paid $20M in dividends or $0.25 per share, translating into a dividend yield of 0.4% in Q2 2022. Given the Fed's hawkish stance going forward, the management remains optimistic about generating incremental capital and putting the excess cash into increasing shareholder value.

"As for capital deployment, our framework remains focused on allocating capital aligned with the returns we get, investing in organic growth first and foremost, pursuing M&A where appropriate, and returning excess capital to shareholders. In Q2, we allocated capital to both organic growth and share repurchases, buying back $50 million of our shares. As we look ahead to Q3, given our improved level of cash

generation, we plan to increase share repurchases to approximately $75 million." - [Matthew J. Audette, CFO]



Source: Investors Presentation – Key Metrics

COMPANY MANAGEMENT

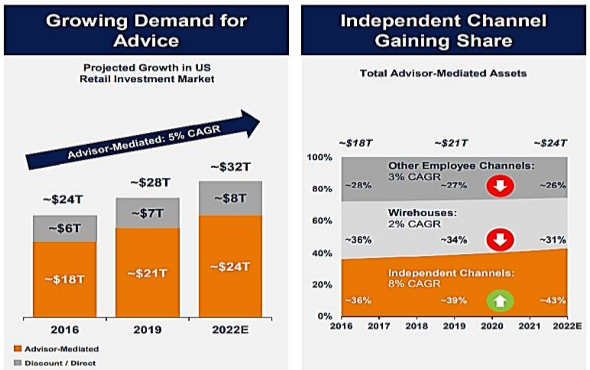
Dan H. Arnold has been serving as the company's CEO since January 2017 and President since March 2015. He joined LPLA in 2007 following the company's acquisition of UVEST Financial Services Group, Inc. Since joining the company, Mr. Arnold held a variety of senior-level roles including the company's CFO between 2012 and 2015. Prior to joining LPL Financial, he spent over a decade with UVEST serving most recently as the President and COO. Mr. Arnold earned a degree in Electrical Engineering from Auburn University and an M.B.A. in Finance from Georgia State University.

Matthew J. Audette joined LPL Financial in 2015 and is currently serving as the Managing Director and CFO of the company. Prior to joining LPLA, Mr. Audette worked at E*TRADE Financial Corporation as the EVP and CFO. He started his career with KPMG in the financial services practice. Mr. Audette holds a B.S. degree in Accounting from Virginia Polytechnic Institute and State University.

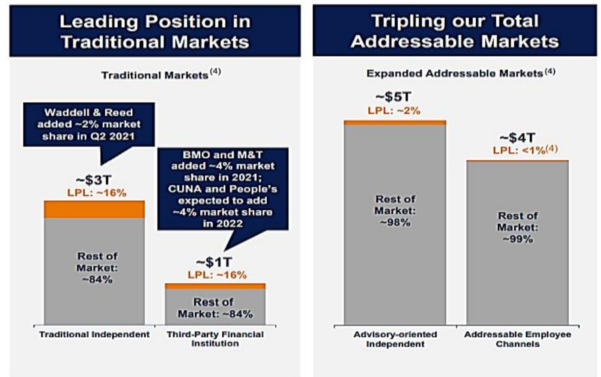
LB•LOGIC We like the fact that the company is guided under senior professionals with years of experience in the industry.

INDUSTRY AND COMPETITION

The demand for advisor-mediated investment advisory is steadily growing with individuals increasingly needing investment professionals to manage their investments both in up and down markets. In the US, the advisor-mediated investment advisory market has grown from $18T in FY 2016 to $21T in FY 2019. The market is expected to grow further at a CAGR of 5% to reach $24T in FY 2022. Independent broker-dealer firms are expected to outgrow other advisor-mediated channels going forward driven by higher payout to advisors and flexible working conditions as compared to Wirehouses and other employee channels. In fact, assets managed by independent channels are forecasted to grow at 8% CAGR and are expected to garner a 43% market share in FY 2022 as compared to 36% in FY 2016.



Source: [Investors Presentation – Q2 2022]



Source: [Investors Presentation – Q2 2022]

The company faces intense competition from other independent broker-dealer firms such as Raymond James, Royal Alliance, Commonwealth, Cambridge, First Allied Securities, and Securian Financials. Additionally, competition from other well-known broker-dealer firms that employ both the full-service and independent channel approach such as Ameriprise, Lincoln, AXA, Wells Fargo, etc. is also a notable one. Despite intense competition, the company held a 16% market share in each of its traditional markets i.e., traditional independent and third-party financial institutions. Moreover, the company has launched several other offerings focusing on breakaway advisors and RIA-only advisors which has unlocked a significantly large addressable market.

LB•LOGIC The company benefits from its market leadership and scale advantage in its traditional markets. It could leverage these business traits to up sell and cross sell other offerings which will not only drive advisor retention rate but will also increase the share of recurring revenue in the business. The recent success with LPL Services Group solutions signifies incremental growth opportunities for the company.

TREND ANALYSIS: VALUATION

The company's stock has been on the rise due to the recent rate hikes by the Fed. In fact, on a 1-year basis, the company's stock has risen over 40% and currently hovers near all-time high levels. This has led it to trade at 23x its non-GAAP earnings on a forward basis, which is a significant premium relative to peers and its own 5Y historical average. We believe that all the near to medium-term growth opportunities pertaining to more interest rate hikes by Fed are already priced in at the current valuation.

Company name	Revenue Growth FWD	Net Income Margin TTM	Price to Earnings FWD	Price to Book value ratio	Dividend Yield FWD
LPL Financial Holdings, Inc.	**18.2%**	**6.2%**	**22.7X**	**9.8X**	**0.4%**
Raymond James Financial, Inc.	13.8%	13.9%	14.3X	2.3X	1.3%
Interactive Brokers Group, Inc.	21.8%	11.4%	20.0X	2.9X	0.5%

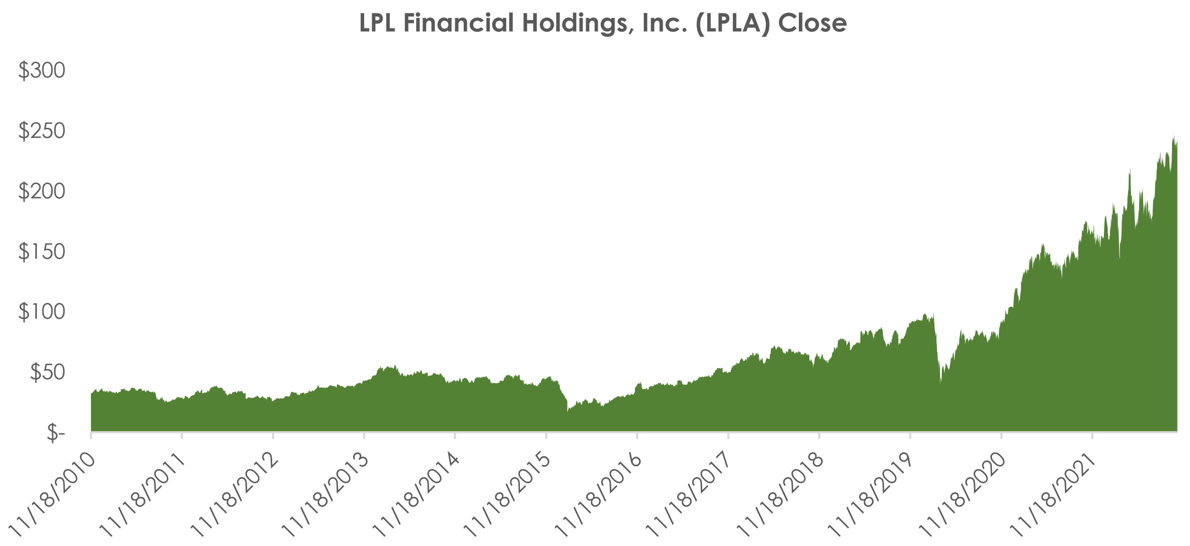
The Charles Schwab Corporation	25.8%	34.0%	18.4X	3.4X	1.2%
XP Inc.	31.2%	28.9%	13.7X	2.9X	-

Source: Seeking Alpha

CONCLUSION / RECOMMENDATION

Leveraging the business model's natural hedge to market volatility and increased adoption of advisor-mediated investment advisory, the company has been able to register solid top and bottom-line growth. Additionally, organic investments coupled with accretive acquisitions have also led the company to enjoy growth in client assets. Despite robust fundamentals, the company is currently priced to perfection and all the near to medium-term growth opportunities relating to further rate hikes seem to be already priced-in. Therefore, we assign a **"YELLOW LIGHT"** rating to LPL Financial Holdings, Inc. (LPLA).

Stock Chart for LPL Financial Holdings Inc. (LPLA)



Performance Data

FISCAL YEAR	2016	2017	2018	2019	2020	2021
RETURN ON INVESTED CAPITAL (%)	8.5%	9.4%	15.5%	19.8%	16.6%	11.5%
NON-GAAP GROSS MARGIN (%)	34.4%	36.3%	37.5%	38.6%	35.8%	31.8%
NET EARNINGS (MILLIONS USD)	191.1	238.9	439.5	559.9	472.6	459.9
YoY EARNINGS Growth (%)	13.7%	24.5%	84.0%	27.4%	-15.6%	-2.7%
REVENUE (MILLIONS USD)	4049.4	4281.5	5188.4	5624.9	5871.6	7720.8
YoY Revenue Growth (%)	-5.3%	5.7%	21.2%	8.4%	4.4%	31.5%

Valuation Data

FISCAL YEAR	2016	2017	2018	2019	2020	2021
SHARE PRICE (USD)	35.8	57.2	59.8	92.6	104.5	160.6
SHARES OUTSTANDING (MILLIONS)	90.1	90.0	84.5	79.6	79.7	79.9
MARKET CAP (BILLIONS USD)	3.2	5.2	5.1	7.4	8.3	12.8
PRICE/SALES RATIO	0.8X	1.2X	1.0X	1.3X	1.4X	1.7X

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