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Advice at a price

If it's financial advice you want, you could ask a Nobel Prize-winning economist (no, not the one at *The New York Times*). Alternatively, you could pay nearly 65 times estimated 2016 GAAP net income to invest in a company that markets highbrow robo-advice. Now under way is a bearish appraisal of Financial Engines (FNGN on the Nasdaq), an advice-proffering brainchild of, among others, William Sharpe, Ph.D., a winner of the Nobel Prize in economics and father of the famous capital-asset pricing model.

Sharpe took home the prize, or rather one-third of the prize, in 1990 (he shared it with Harry Markowitz and Merton Miller). He founded the company, or rather one-third of the company, in 1996 (his co-founders were Joseph Grundfest and Craig Johnson). Financial Engines unveiled the first independent online advice platform in 1998. It went public in 2010.

Today, Financial Engines is the leading provider of financial advisory services for direct-contribution plans in the United States. It manages assets worth \$113 billion and performs this feat with fewer employees than you might suppose it would need—about 550, not including the staff of The Mutual Fund Store, which enterprise Financial Engines bought a couple of months ago. Software does the work that humans don't. Tell it a little something about yourself: age, wealth, risk tolerance, time horizon, investment strictures of your 401(k) plan. It, in turn—Advice Engines is its name—will tell you where to put your nest egg.

Financial Engines has sales of over \$310 million and an equity-market

cap of \$2 billion. Principal contributor to the top line are professional management fees, which vary with AUM; they accounted for 89% of revenue in 2015. The company serves both as a direct advisor, where it acts as primary fiduciary under contract with the plan sponsor and plan provider, and as a sub-advisor, where its contract is solely with the plan provider and its services are co-branded. In 2015, four plan providers paid sub-advisory fees representing 32% of overall revenue. Platform fees—charged for access to the software—constitute a secondary source of revenue; they chipped in 10% of last year's top line.

You can't blame Dr. Sharpe for the valuation. Nor can you praise him, as—according to the proxy—he's no longer involved with the company; Mr. Market will have to answer for that empyrean multiple. But a multiple of what? The enterprise is valued at 16 times expected "adjusted" EBITDA for 2016, which adjustments include the amortization of both deferred sales commissions and of direct advertising costs. That would be more expensive than the average publicly traded financial-data company—such as a Factset or Morningstar—and well in excess of the 9.7 multiple for the average listed asset manager. The shares may likewise be quoted at over 31 times expected "adjusted" 2016 earnings per share, which adjustment adds back stock-based compensation expense. It's no small expense, as management shelled out \$48 million on a 12-month buyback plan ended late last year to repurchase 1.3 million shares, or 2.5% of the shares outstanding when the program started.

Still, despite that outlay, almost as much as last year's operating profit, the basic share count barely budged (which is to say that stock-based compensation kept pace with stock repurchases).

Anyway, the bulls contend, the company is worth every penny. They observe that assets under management have been rapidly growing, to the aforementioned \$113 billion from \$47.5 billion at the end of 2011, and that the potential advisory market is immense: There was nearly \$7 trillion invested in direct-contribution retirement plans at the end of 2014, according to figures cited by Financial Engines. "In the long-term," Surinder Thind, equity analyst at Jefferies LLC, tells colleague Alex Hess, "we anticipate that this is a business model in which scale matters. And with scale comes operating leverage."

On Feb. 1, Financial Engines closed on its \$516 million acquisition of The Mutual Fund Store, a vendor of investment advice that, so Thind contends, will profitably complement the services of the parent. TMFS operates out of 129 locations, has 345 employees, 84,000 accounts and \$9.8 billion under management. Its forte is the human registered investment advisor. Because the new acquisition deals less in software and more in personal service, it will capture, the reasoning goes, the many Financial Engines clients who, upon retirement, need someone to talk to besides a computer screen.

As Raymond J. Sims, the parent's CFO, noted in a January presentation at the ICR XChange conference, the average Financial Engines advisor handles a whopping 10,000 customers, far more than the typical TMFS advisor's

300 to 400. With just 140 registered advisors spread across those 129 locations, TMFS may have to bulk up, both in staff and office space. If so, one might wonder if the operating-leverage narrative will play out as the bulls imagine. If not, the question arises of whether the acquisition is really worth the evident multiple of around 12 times trailing-12-month EBITDA that Financial Engines said it paid upon announcing the deal last November? (The company declined to comment.)

At all events, anticipation runs high. If sell-side projections are on the beam, Financial Engines' operating profit will reach \$93.7 million in 2017, up from \$49 million in 2015. As for 2019, one optimist goes so far as to pencil in \$182 million, a more than threefold leap from 2015 results.

Where the bulls and the bears fall to quarreling is over claims about operating leverage. Newly signed-up clients—so the bulls maintain—will deliver wonderful growth. They will do nothing of the kind, the bears counter. The newbies, by definition, are younger and less affluent than the retirees who annually drop off Financial Engines' rolls. "FNGN's costs increase with each new enrollee," Robert Buckley, a short-seller of the stock and co-

founder of Buckley Lloyd Partners, advises his clients. "So what will happen to margins if the market doesn't continue its upward trajectory and the average enrollee 401(k) balance actually falls? Or if the market declines and enrollee churn picks up?"

While operating margins, according to the bulls, *should* be expanding as the company scales up, the facts would seem to point in the opposite direction. Gross profit margin has fallen for the five past years, to 57.8% in 2015 from 66.4% in 2010. Incremental operating margin, defined as year-on-year change in operating income divided by year-on-year change in revenue, tells a similar story. In 2014, it registered 37%; in 2015, minus 40%.

"Such incrementals look to be even worse in 2016," Hess proposes. "Last year the company reported adjusted EBITDA—'adjusted,' mind you—of \$96 million. This year, it predicts adjusted EBITDA on the order of \$114 million, a total that includes the contribution of TMFS. Now, it is not entirely clear what the new acquisition will contribute; based on public statements about the acquisition price, we'll say \$43 million. If true, that would imply that the core Financial Engines business will generate just \$71 million in

adjusted EBITDA, a \$25 million decline from 2015. Assume a cost structure identical to last year's, and operating income for the core business for 2016 looks set to drop to \$30 million or less, down from \$49 million in 2015."

With relatively flat costs of revenue per customer to service these assets, the company can be said to exhibit diseconomies of scale. "At the end of the day," Buckley contends, "FNGN faces a structural defect. Its most profitable customers, those with the highest account balances, often walk out the door when they retire, and simply replacing one large account with five small ones won't work. This is because costs are proportional to customers, not AUM."

Or one may think of the problem in terms of the median and the average: As older, wealthier clients leave, Financial Engines' average account, now \$118,000, converges towards the (lower) median account, now \$53,000 to \$54,000.

The bearish case can't be entirely unpersuasive. In the past 12 months, Financial Engines insiders have sold more than 223,000 shares for a total consideration of \$8.9 million. Their recorded open-market purchases are nil.

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