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VCTR - Q1 2018 Victory Capital Holdings Inc Earnings Call

EVENT DATE/TIME: MAY 08, 2018 / 2:00PM GMT

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PRESENTATION

Operator

Good morning and welcome to Victory Capitals First Quarter 2018 Earnings Conference Call. My name is Nicole and I'll be your conference operator today. (Operator Instructions) Please note that this conference is being recorded.

I would now like to turn the conference over to Lisa Seballos, Director of Finance from Victory Capital. Please go ahead.

Lisa Seballos - *Victory Capital - Director of Finance*

Good morning. Before I turn the call over to David Brown, I'd like to note that today's discussion may contain forward-looking statements. And as such, includes certain risks and uncertainties. Please refer to our press release and our SEC filings for more information on the specific risk factors that could cause our actual results to differ materially from the projections described in today's discussion.

While the recording of this call will be made available by us on our website, any forward-looking statements that we make on this call are based on assumptions as of today. And we undertake no obligation to update these forward-looking statements to reflect new information or future events that occur or circumstances that exist after the date on which they are made.

In addition to U.S. GAAP reporting, we report certain financial measures that do not conform to generally accepted accounting principles. We believe these non-GAAP measures enhance the understanding of our performance. Reconciliations between these GAAP and non-GAAP measures are included in the tables found in our earnings release and the slide presentation accompanying this call, which can be accessed on the investor relations portion of our website located at ir.vcm.com.

Now I would like to turn the call over to David Brown, Chairman and CEO.

David Brown - *Victory Capital - Chairman and CEO*

Good morning and welcome to Victory Capital's first quarter 2018 earnings call. I'm joined today by Terry Sullivan, our Chief Financial Officer; and Mike Policarpo, our Chief Operating Officer.

I'm going to spend a few minutes discussing highlights of our Q1 results as well as our long-term strategy and then I will turn it over to Terry, who will review our financial results for the quarter in more detail. Following our prepared remarks, Terry, Mike, and I will be available to take questions.

We'll start on Slide 6. In a quarter that marked a return to higher levels of volatility for the equity markets, I'm pleased to report that Victory Capital delivered very solid results. Relative investment performance across our investment franchises and our solutions platform remained strong with 87% of our AUM outperforming its respective benchmarks over the trailing one year, 71% over the trailing three-year, 83% over the trailing five-year, and 79% over the trailing 10-year.

Looking at performance based on the number of strategies, 75% of our strategies outperformed benchmarks over the trailing one year, 70% over the trailing three-year, 76% over the trailing five-year, and 72% over the trailing 10-year.

Additionally, as of March 31, 2018, 69% of our AUM in our mutual funds and ETFs earned four or five star ratings overall from Morningstar, 59% over three years, 68% over five years, and 66% over 10 years.

Assets under management declined slightly for the quarter to $60.9 billion due to net outflows of $633 million and market depreciation. Given the lumpiness of our business quarter to quarter when it comes to flows and the higher than normal levels of client rebalancing activity we have experienced, the outflows this quarter were not outside of our expectations. These results come on the heels of a net flow positive Q4 2017, which really highlights the importance of looking at flows on an annual basis versus quarter to quarter.

The long term fundamentals of our business remains strong and our "won but not yet funded" pipeline as well as our sales pipeline for the remainder of 2018 are healthy. Moreover, I'm very pleased with the momentum we are seeing in our emerging product flow leaders as we transition from the current product flow leaders.

Additionally, we continue to achieve strong sales momentum in our VictoryShares ETFs with net flows of $452 million for the quarter. AUM in our ETFs grew to $2.7 billion, an increase of nearly 19% quarter over quarter.

Lastly, we did a very nice job executing on our financial plan in the first quarter. The long-term stability in our capital structure following our IPO has been very well received by our clients. I'm pleased with how we performed in the quarter as it relates to our earnings, our margins, and our capital plan despite some of the industry headwinds. We're working hard to continue this strong execution through the remainder of the year.

This is our first earnings call as a public company, so before I turn over to Terry to review the financials for the quarter in more detail, I'd like to provide a brief overview of our business and our long-term growth strategy which begins on Slide 8.

The foundation of our business is built on four key pillars that exemplify our culture and our commitment to our clients. These pillars are rooted in the belief that trust, investment autonomy and meaningful employee ownership in our firm and our strategies will lead to better long-term results for our clients. Our commitment to these pillars has helped to create a very unique employee culture and we believe it serves as a key driver of our success both today and in the future.

On Slide 9, we provide a snapshot of Victory Capital and our next generation integrated multi-boutique business model. Our nine investment franchises, which is our term for boutique/affiliate are operationally integrated, but are separately branded and make investment decisions independent from one another. We also offer a solutions platform that consists of multi-franchise and customized solutions strategies that are primarily rules based. This includes our VictoryShares ETF brand. Our franchise and solutions platform are supported by a truly centralized distribution, marketing, and operations platform that enables our investment professionals to primarily focus on delivering investment excellence on behalf of our clients.

We have a 113 investment professionals across 13 offices worldwide, 10 of which are in the U.S. Importantly, our operating platform is "centralized but not standardized." By that I mean that our investment franchises want their investment information delivered in a certain way and within a certain timeframe so they can maintain their investment edge. So, we customize the way in which we deliver it to them. We take this approach throughout the platform, so as not to lose the uniqueness of each of our franchises while providing them with the benefits of a fully scaled operating platform. We sell to both the institutional and retail channels in the U.S. and outside and have more than 70 strategies spread across a wide variety of asset classes and investment vehicles that we purposely selected.

We support those strategies with a scaled client service platform that includes nearly 100 sales and marketing professionals. Since our MBO in 2013, we have successfully completed three acquisitions and one minority investment. We believe we are well-positioned and experienced in sourcing and executing on transaction that will make our platform stronger and allow us to serve our clients better.

On Slide 10, we compare and contrast our business model to others in the industry as we believe we have a unique approach. It is not uncommon for multi-boutique firms to have distinct branding and provide some level of autonomy to their investment affiliates. However, we take that one step further by enabling all of our investment franchises to do their own research and portfolio construction. They are not sharing information or forced to employ an investment approach that does not work for them.

On the distribution side, our model is truly centralized where many others in the industry are not. We have a centralized distribution team with dedicated institutional and retail sales groups that sell all of our products. Our sales professionals carry one business card with Victory Capital on the front and all the franchise logos on the back. We believe our model makes it more efficient for our clients to partner with us. It also is more cost effective and it fosters cross-sale opportunities particularly on platforms where we have multiple products on recommended lists. This applies both on the institutional and retail sides of the business.

The ability to approach distribution in a scaled way is an important differentiator for us, we believe, as platforms and allocators in most distribution channels continue to reduce the number of firms with whom they are doing business.

Our model has also given us the opportunity to build scale in operations, administration and technology and has allowed us to reinvest efficiently in the business with the goal of providing best in class service to the franchises. It also enables us to invest once versus nine times which we believe is another distinct advantage of our structure.

Finally, our model is conducive to M&A, which I will cover in more detail later in the presentation.

Let's turn to Slide 11, we have the diversification of a larger business and that's important when we think of the health and sustainability of the business through all market cycles. We are diversified by business channel with approximately 58% of our AUM from institutional clients and 42% from retail clients as of the end of quarter. We believe this client diversification has a stabilizing effect on our revenue and earnings as institutional and retail investors tend to exhibit different allocation patterns and respond to industry trends in different ways. Additionally, having access to both channels give us a better opportunity to attract new clients in all market cycles.

Our diversified business platform features a suite of active products and hybrid rules-based solutions including our proprietary ETF brands, VictoryShares. Within those categories, we offer wide range of asset classes and distinct investment approaches. Our clients choose from a suite of 72 investment strategies managed by our nine franchises or our solutions platform. Each of our franchises employs a distinct investment approach and is producing its own unique alpha, which we believe leads to real diversification in investment return streams among franchises even when we have multiple franchises investing within the same asset class.

We call this concept Investment Performance Diversification and believe it deserves greater focus from an industry perspective because it is a part of the foundation of a healthy long-term business.

Turning to investment performance on Slide 12. I'd like to share our score card which we believe provides strong evidence that our unique culture and our platform, which allows our investment professionals to spend primarily all of their time producing investment results, is working for our clients.

Our franchises have established a long history of outperformance relative to their respective benchmarks and that track record has received notable industry recognition. Victory Capital was ranked 10th amongst "Barron's Best Fund Families" for 2017, our fourth consecutive year in the top 25. We also received a second place ranking in the Mixed Asset category for 2017.

We believe our strong results were also helping to increase our industry brand recognition. In a study published by eVestment in January of this year, Victory Capital was ranked fourth in institutional brand awareness for the second year in a row among investment managers with $50 billion to $100 billion in AUM.

Moving to Slide 15, in assembling our portfolio of franchises, we have selected investment managers with expertise in specialized asset classes where active managers have demonstrated and established track record of outperformance relative to benchmarks through security selection and portfolio construction. We continue to build our platform to address the needs of clients who would like exposure to asset classes that have greater potential for alpha generation.

Strategies in these asset classes have historically experienced less fee compression than strategies in more commoditized asset classes and we believe demand for them typically exceeds capacity. These asset classes which we call our "focus" asset classes include our solutions platform, global, and non-U.S. equities, U.S. mid cap and U.S. small cap. 19 of our 29 mutual funds and ETFs in these asset classes have earned four or five star overall ratings from Morningstar as of March 31 and we have an aggregate of $116 billion of open capacity across those four and five star funds.

On Slide 16, we highlight the compelling opportunity that comes from our solutions products particularly ETFs. Since we introduced ETFs to our platform in 2015 with the acquisition of CEMP, our ETF assets under management have grown from a $198 million to $2.7 billion. Over the past four quarters, our market share has increased by 71%. VictoryShares is the second fastest growing ETF provider with more than $1 billion in AUM and three of our original ETFs have achieved their three-year track records and are rated five stars overall by Morningstar as of the end of March.

From a fee perspective, our ETFs are priced at 30 to 45 basis points. This is important because it means that we are not directly competing with the big passive players, instead we have developed a suite of ETFs that help to bridge the gap between the active and passive elements of an investor's portfolio. We think we are in early stages of this trend and that client demand will continue to increase.

We're also committed to continue to expand the platform to meet our clients' needs. Since the beginning of 2017, we've launched three new ETFs, two that track indices that were developed in partnership with NASDAQ and one that expands our suite of volatility weighted ETFs to include exposure to emerging market equities. We also continue to evaluate new product ideas and partnerships in this exciting part of our business.

Slide 17 highlights our M&A strategy. Victory Capital has a proven track record of successfully acquiring and integrating investment firms and achieving significant synergies. We believe our differentiated platform which combines operating scale and investment boutique like qualities makes us a compelling acquirer for investment firms in today's environment given industry trends.

We intend to continue to accelerate growth through disciplined acquisitions. We generally seek targets that can provide us with enhanced investment offerings, complimentary products and investment strategies, additional financial strength, and/or a broader distribution footprint. Our focus is not only on U.S. investment managers, but also on opportunities, investment styles and footprints that have an international or an emerging markets presence.

Through our acquisitions to date, we've added franchises that we believe can outperform the market over a full cycle and where we have strong understanding of the core business' ability to drive growth for those franchises and our company as a whole. Depending on the circumstances, we would also consider acquisition and investment opportunities outside of what we have done historically.

Our current pipeline of acquisition opportunities is extremely strong and we are encouraged by the level of activity we are seeing.

Let's turn to Slide 18, we believe the universe of potential acquisition targets has grown as a result of the distribution landscape, the increasing cost of regulatory compliance, management fee compression, and outflows from actively managed funds to passive products.

In the United States, investment management firms with up to $100 billion of AUM collectively manage approximately $9.3 trillion of AUM. We intend to focus our acquisition effort on firms with $10 billion to $75 billion in AUM. This is a size range in which we have successfully executed two transactions, the acquisitions of Munder Capital Management and RS Investments, and in which investment management firms in the U.S. collectively manage approximately $5.8 trillion of AUM. Although this is our focus, we would consider firms outside this range if the opportunity warrants it.

Moving to Slide 19, I'd like to touch again on our ownership culture. We have created a strong alignment of interest with our clients through employee ownership in our company and in our investment products and through our franchise revenue share structure. We believe the opportunity to own equity in a well-diversified public company that is structured like ours is attractive, both to existing employees and those who joined the firm through acquisitions.

We have over 80% of our employee base who are holders of VCTR, it is an important component in attracting new talent and contributes to a very high retention rate of our employees. We principally compensate our investment professionals through a revenue share program, which we believe provides further incentives for franchises to focus on investment performance while simultaneously minimizing potential distractions from the expense allocation process that would be involved in a traditional profit sharing program.

Organizationally, our operation and financial platform leaders manage the expense side of the equation and believe that they do it very well. Additionally, our employees have elected to invest more than $100 million in products that we manage, directly aligning their investment outcomes with those of our clients and adding to the ownership culture. We believe the combination of these cultural mechanisms has promoted long-term thinking, enhanced the client experience and ultimately created value for our shareholders that will continue in the future.

Finally, on Slide 20, I'd like to wrap up my comments by discussing our future strategy and how we're going to grow. We have three levers of growth which we believe differentiates us from traditional investment management firms. First, we seek organic growth by leveraging the specialized capabilities of our existing franchises and our solutions platform and selling their products through our distribution system. Second, we seek inorganic growth through value creating strategic acquisitions. Finally, like all investment managers, we can grow as a result of market action.

Looking first at organic growth, I talked about our Focus Asset Classes. Over the past three years, as of March 31, 2018, we've achieved $4.8 billion of new net flows in these Focus Asset Classes in active equities and ETFs, $3.5 billion over the past two years. Going forward, we intend to continue to focus on strategies in these specialized asset classes and to drive sales through our nearly 100-person sales and marketing group. We're also going to continue to reinvest in our scaled distribution, operating and technology platform.

Importantly, as I said earlier, because our platform is integrated, we only need to invest once, not nine times. And we remain committed to expanding our product platform with innovative strategies that are designed to deliver specific client outcomes.

Looking next at inorganic growth, I discussed in depth our M&A track record and the benefits we bring to potential partners. In our opinion, being a public company, structured the way we are today only exemplifies this strength. As in the past, our strategy is to identify franchises that fit with us culturally put them on our platform and give them the autonomy and the resources that they need to be successful. In many cases, those resources are better than what they have today. Once they are on a platform and perform well, we'll sell the strategy that they manage through our distribution channels and relationships.

The key with each acquisition is to better the overall platform that we offer to our clients. The achievement of synergies is a positive byproduct of the process which provides a head start if you will in the value creation process.

One other point to consider is that as a company of our size any strategic progress that we make will be impactful. For example, if we do an acquisition, it has the potential to have a much greater impact on the fundamentals of our business than it would for a larger firm.

Now, we'll turn it over to Terry to discussion our financial results.

Terry Sullivan - *Victory Capital - CFO*

Thanks, Dave. The financial results review for the first quarter of 2018 begins on Page 22. We're pleased to report very solid results for the quarter. AUM ended the period at $60.9 billion down 1.5% due to the negative market action and net flows.

Revenue decrease slightly to a $105 million. Our ANI with tax benefit EPS was $0.40 and EBITDA margin was 37.9%. Both measures were in line with fourth quarter 2017.

The first quarter was effective for Victory Capital from a capital management perspective. We concurrently executed a successful $167 million IPO and $360 million debt refinancing. The IPO marks an important step in the evolution of our capital structure and provides a strong foundation for future growth.

The IPO proceeds along with the use of free cash flow enabled us to reduce our debt level 35% from year end 2017 levels to $323 million at the end of the quarter. We also lowered our cost to debt by 250 basis points to LIBOR plus 275 basis points. In April and early May, we used additional cash flow to pay down debt to $305 million and upsized our credit revolver to $100 million.

Lastly, our capital management activities were recognized by the rating agencies as both Moody's and S&P upgraded us to Ba3 and BB respectively.

Slide 23 provides more perspective on our AUM progression. As Dave discussed earlier, our business has diversification elements consistent with those of larger asset managers. Our assets are diversified across nine distinct investment franchises and a solutions platform, eight asset classes, 72 investment strategies and two broad distribution channels in institutional and retail markets. Our AUM grew 8% from Q1 2017, eclipsing the $60 billion level in late 2017.

Slide 24 highlights our organic growth performance over the last several quarters. A few points to note here. The traction our products are gaining due to strong investment performance, attractive asset class positioning, and a strong distribution system is evidenced by the high gross sales we achieved quarter over quarter.

Our ETF business, VictoryShares, had positive net flows of $452 million in the first quarter maintaining its strong momentum. In fact, March 2018 marks the 23rd consecutive month of positive net flows for our ETF offering. We also maintained traction with our global/non-U.S. capabilities notably with our Trivalent Investments and Sophus Capital franchises.

Also note that the Sophus emerging market strategy just achieved its five-year track record on March 31 and is ranked in the 18th percentile by eVestment in the Global Emerging Markets All Cap Core category for the five years ended March 31, 2018. Momentum here and with VictoryShares is reflective of the new product flow leaders we are seeing develop very well in our business.

We ended the quarter with $633 million in outflows after a positive net flow fourth quarter 2017 as we experienced relatively high levels of client rebalancing, particularly in domestic equities. We believe it's important to take a long-term view on organic growth in the sector and specific to our business.

Quarterly flows results can be heavily impacted by the lumpy nature of the asset management business and timing of client fundings. From a full year 2018 perspective, we're confident in the fundamentals of our business, our excellent investment results provide a foundation for organic growth, our "won but not yet funded" pipeline is strong and our sales pipeline is healthy.

Slide 25 provides a snapshot of quarterly revenues. Revenues grew 4% year-over-year with fee decreases driven by a shift in our asset mix offsetting 10% average AUM growth. Quarter over quarter revenues were slightly down as a result of the same dynamic and two fewer days in the quarter. The composition of our AUM in terms of asset class, vehicle, and client type has driven our average fee rate to levels that continue to be relatively higher than industry averages. Our first quarter 2018 average fee rate was 69 basis points, a 1% quarter over quarter decrease.

Our perspective on expenses is provided on Slide 26. Expenses decreased 3% year-over-year reflecting the completion of the integration of RS Investments and operational efficiencies. Expenses were basically flat quarter over quarter at $91 million. We have aggregated expenses into three categories: personal, operating, and non-operating. A few points to highlight here.

Personal expenses rose slightly year-over-year as a function of higher earnings. It's worth highlighting the variable nature of our expense base as personnel and other variable items will tend to move in line with the revenue, a benefit of our financial model from our perspective.

Operating expenses decreased 10% from the first quarter of 2017. In this category, we had reductions in broker dealer distribution expense, occupancy, and the run off of legacy intangible amortization and restructuring charges. Lastly, non-operating expenses rose 6% quarter over quarter, this is primarily driven by one-time cost related to the debt refinancing we executed that offset lower interest expense.

Slide 27 provides a view on our non-GAAP metrics, as a reminder, we provide these measures to investors as these are the same financial metrics management uses to assess operating performance and we believe are most reflective of Victory Capital's economic performance. ANI with tax benefit increased 14% quarter over quarter, primarily driven by an increase in non-GAAP pre-tax income, a reduction in our tax rate resulting from the 2017 Tax Cut and Jobs Act and a decrease in interest expense and financing cost.

Year-over-year ANI with tax benefit increased 47%, primarily driven by higher revenues, EBITDA margin expansion, and the previously mentioned tax cut and reduced interest expense.

Adjusted EBITDA was $39.8 million, up 18% year-over-year, and flat to the fourth quarter of 2017. Our adjusted EBITDA margin expanded 450 basis points year-over-year.

Lastly, we currently estimate our 2018 tax rate to be approximately 25% in light of further analysis we completed in the first quarter.

Slide 28 provides a GAAP to non-GAAP reconciliation of ANI with tax benefit and adjusted EBITDA. Given this is our first call as a public company, we thought it would be helpful to take the time and briefly walk through the financial metrics the management team uses to assess operating performance.

In terms of ANI with tax benefit for the first quarter, we added back the following: Debt issuance cost of $6.7 million which are related to the debt refinancing we executed in the quarter; GAAP intangible amortization of $5.7 million, which is related to past acquisitions and runs off in a relatively short finite term; Stock-based compensation of $3.3 million, which is amortized over vesting periods and are related to past transaction events like our previous acquisitions and recent IPO;

Acquisition and restructuring cost of $518,000 also a result of the IPO and past acquisitions. These are items such as third party advisory fees, mutual fund proxy solicitations and vendor contract early termination cost that are non-recurring and as such as run off in the short term;

Business taxes of $375,000 related to specific state commercial activity; Pre-IPO governance cost of $141,000 paid to our private equity partners that were terminated upon completion of the IPO and thus will not exist after this quarter. We then tax effect these adjustments at our estimated current tax rate of 25% resulting in a reduction of $4.2 million;

Additionally, we provide the quarterly value of the tax benefit of goodwill and acquired intangibles which was $3.3 million. Due to our acquisitive nature, tax deductions allowed on acquired intangible assets and goodwill provide additional supplemental economic benefit. This tax benefit is included to show the full economic benefit of these deductions.

The addbacks related to adjusted EBITDA include the items I just covered as well as: Interest expense of $8.1 million which reflects not only the interest expense for the quarter partially at the higher debt level and borrowing cost we had prior to the IPO and debt refinancing, but also $1.9 million of debt extinguishment expense related to the first quarter 2018 debt refinancing; Operating depreciation of $736,000; and losses for equity method investments of $137,000.

We have also provided more detailed reconciliations and definitions of our GAAP to non-GAAP metrics in the appendix and our earnings release.

Turning to Capital Management, Slide 29 outlines several key balance sheet items and metrics. As I mentioned earlier, we closed the quarter at $323 million in debt outstanding yielding a net debt to credit EBITDA ratio of two times. Subsequent pre-payment activity has resulted in a current debt balance of $305 million. Through our recent capital management activities, we reduced our debt 15% from the time of our IPO. The debt refinancing enabled us to decrease our borrowing cost to LIBOR plus 275 basis points, a reduction which translates to approximately $8 million in annualized interest expense savings at our current debt level.

We increased our credit revolver to a $100 million, which we believe is more in line with a company of our size and is supportive of our growth strategy. We continue to proactively manage our balance sheet and capital policy in accordance with our overall growth strategy.

This concludes our prepared remarks. I would now like to turn the call over to the operator for questions.

Operator

Thank you. (Operator Instructions) Our first question comes from the line of Michael Cyprys of Morgan Stanley.

Michael Cyprys - *Morgan Stanley - Analyst*

Just on the M&A front, if we could just talk about that for a little moment. As you're thinking about your story, just curious what resonates in the conversations you're having with potential target in terms of why would someone sell to Victory as opposed to some of the other boutiques that are there. What is most compelling about your value proposition with potential targets?

David Brown - *Victory Capital - Chairman and CEO*

So this is David, a couple of things. First is we are seeing a lot of activity. We are busier really than ever from an M&A perspective. We're having a lot of conversations and what we're hearing in the market and what we've heard in the market before is our integrated platform which really allows a firm to kind of come onto our platform and then utilize all the strengths of our platform or distribution, our marketing, our operational and technology expertise is a real differentiator.

And especially in today's environment, our track record, the idea that a firm can come in to our platform and actually speak to other employees that have been from other firms and see the experience that they've had is a real differentiator as well.

Michael Cyprys - *Morgan Stanley - Analyst*

Great. And just as a follow up question on that M&A, just curious how you think about prioritizing different types of transactions that you could do -- firms that could add other product capabilities such as alternatives or firms that could maybe can enhance your distribution or firms that maybe provide cost synergy opportunities. How are you thinking about that, what's most important today to Victory as you're thinking about that current stage of evolution of the company from the M&A front?

David Brown - *Victory Capital - Chairman and CEO*

So we really start first and we look at the product set, and what's most important to us is does the product fit within the client's portfolio. Is it a product for the future? Is it an innovative product? So we want to buy businesses partner with organizations that actually produce products that matter for today and really for tomorrow.

From there, we want to be as we've said all along, we want to be in asset classes that have the right attributes that can win going forward from an active management perspective, have all the attributes of a product where you can still hold pricing because it matters within the clients portfolio where potentially the organization in addition to the product could make our business better maybe from a distribution perspective, maybe from an operational perspective.

And when I think about prioritizing, I start off with really the product set and how it fits and then from there, it really just depends on the specific opportunity.

Michael Cyprys - *Morgan Stanley - Analyst*

Got it. If I could just squeeze one last one in here because you mentioned the pipeline was pretty strong on M&A, any sense on timing how we should be thinking about that?

David Brown - *Victory Capital - Chairman and CEO*

No sense on timing. Let me make this clear. I mean we have not done an acquisition in over a year. It's not because we haven't had the opportunity, it's not because we've been disadvantaged by the model or pricing or anything else. We are just highly disciplined and selective. So we are waiting for the right one, and when that one comes along, we're fully prepared to execute on it. But as I said, we're having lots of conversations, it is probably the busiest we've ever been on that front.

Operator

Thank you. Our next question comes from the line of Michael Carrier of Bank of America Merrill Lynch.

Jeffrey Ambrosi - *Bank of America Merrill Lynch - Analyst*

It's actually Jeff filling in for Mike. I guess just first on flows in the quarter in terms of the client rebalancing, just wondering if you can maybe size that potentially for us and are you seeing that continuing in 2Q?

Terry Sullivan - *Victory Capital - CFO*

Yes. Hi, it's Terry. I'll take that question. I think that in terms of the rebalancing, what I'd say is that it's as you know a function of strong investment performance in a lot of ways and it continues to be a major component of the outflows that we saw this quarter. It follows on the heels of a positive quarter from the fourth quarter where we felt it was a little bit more neutralized.

So I'd say, generally, it's something that we're starting to see lighten up a little bit and that's really been expressed from a financial standpoint in our strong "won but not funded" pipeline, and our general healthy sales pipeline.

Jeffrey Ambrosi - *Bank of America Merrill Lynch - Analyst*

Okay, thanks. And then maybe on that pipeline would you be able to size that for us or maybe talk about I guess from like a fee rate point of view, like how the mix is and the pipe?

Terry Sullivan - *Victory Capital - CFO*

Yes, I'd say that we're not really quantifying the pipeline. Dave talked a little bit about the lumpiness of the business. And so I think you have to look at this a little bit more holistically and long term, so that's not something that we quantify.

I'd say from a fee standpoint, we're seeing the pipeline widespread across our franchises and vehicles and as such there's no real movements one way or another relative to the fee levels that you just saw from us in the last quarter.

Operator

Thank you. Our next question comes from the line of Ken Worthington of JP Morgan.

Ken Worthington - *JP Morgan - Analyst*

So can you talk about the progress and transitioning both the sales force and your clients away from the two big Sycamore funds to some of the other SMid products and global products that are performing so well. So basically, how is that transition coming?

And then the follow up on the pipeline question, which products or franchises seem to be driving the pipeline success? You talked about it doing well, are there certain pockets that seemed to be gathering more success and that, really that institutional pipeline than others?

David Brown - *Victory Capital - Chairman and CEO*

Sure. Thanks, Ken. It's Dave. To answer your first part of your question, let me clear up on Sycamore as well. Although the Sycamore small cap is closed and the Sycamore mid cap is soft closed, we are still accepting assets or flows from existing clients. And we anticipate that we'll have some activity on that franchise this year. So that is still if you will bringing on assets, but when we think of really the transition from our current flow leaders which Sycamore is one of them, we think about the future and the transition around VictoryShares, which is happening today and you could see in the numbers. Trivalent has had a lot of progress, great investment performance and a lot of momentum.

And then really when we think about the emerging flow leaders, we're thinking about Sophus, which Terry mentioned the five-year track record that just has come on. We've invested heavily in the marketing of that franchise.

VictoryShares as good as the momentum has been, we see that increasing looking forward as the performance continues to do well and as we gain access to new platforms. RS growth has really come on and we're very excited about that. And then we also think Integrity has a lot upside in a couple of their products and really that's just the shorter to mid-term. And then the longer term, we have obviously some of our other franchises, which are building nice track records.

And as far as -- and I would say lastly Ken on the pipeline question, I would say the aforementioned franchise really fill up the pipeline of when we think of who's in the pipeline, we are -- when I think of our pipeline, I think of the words widespread, healthy, and then really supported by excellent investment performance.

Ken Worthington - *JP Morgan - Analyst*

Great. And then maybe to follow up on Michael's question earlier, talk about the deal pipeline. You said that you're maybe more active than you've ever been, in your conversations with potential sellers, what's really bringing them to the table? What's driving them today when they might not have been coming to the table a year or two ago?

David Brown - *Victory Capital - Chairman and CEO*

It's Dave. I think the industry landscape, the lack of access to distribution on both sides be it institutional and retail. Typically, we are talking to groups that might have access to one channel and maybe not both channels. The continued need to reinvest in their technology and operating platform and I think those are the two driving factors.

Operator

Thank you. Our next question comes from the line of Kenneth Lee of RBC Capital Markets.

Kenneth Lee - *RBC Capital Markets - Analyst*

Just want to follow up on the potential deal activity, as you mentioned in your prepared remarks, there's a potential for you guys to look at targets outside of the historical opportunities set. Just wondering what factors could lead you to look at outside the opportunity set?

David Brown - *Victory Capital - Chairman and CEO*

It's Dave. We evaluate a lot of different factors and metrics when we look at opportunities, probably one of the most important one is does it make our company better. I can't give you a specific metric or factor on why we would go outside, but the driving factor would be does it make our company better.

We evaluate each deal individually, we have engaged and looked at things that are outside of the scope. And we've chosen not to do anything, that doesn't mean we won't do something in the future that's outside of what we've traditionally done. We're very flexible.

Kenneth Lee - *RBC Capital Markets - Analyst*

Great. And just one quick follow up, when you think about potential financial capacity for conducting transactions. How would you size that? Thanks.

David Brown - *Victory Capital - Chairman and CEO*

When we think about capacity, we really think that we have all the tools we need to execute on the transactions we're looking at. And really to date, we have not been handcuffed from a tool set perspective.

Operator

Thank you. Our next question comes from the line of Jeremy Campbell of Barclays.

Jeremy Campbell - *Barclays - Analyst*

So just looking at like the flows in your ETF that obviously it's been a growth driver and if I'm remembering correctly, a lot of your ETFs are kind of positioned to outperform during enhanced volatility. So I'm just wondering if you guys could talk a little bit about the performance and flows of those products specifically during the big February spike and also if you're getting increasing interest in the strategies from retail or institutional type investors now that volatility has come back a little bit more this year?

David Brown - *Victory Capital - Chairman and CEO*

Yes, it's Dave. I would keep in mind that our ETF product set, we believe - and from the information that we've seen, does well really in all market environments, doesn't really do any better in a volatile or a highly volatile or less volatile market. We've seen great strength this quarter, it's continuing in April and we really have a lot of momentum there.

We're seeing a lot of interest and a lot of activity and we think that the ETFs are really all weather products and not specifically positioned to do for client's portfolios in certain volatile markets, we think it fits in a portfolio long-term.

Jeremy Campbell - *Barclays - Analyst*

Okay. But there are kind of volatility overlays in a lot of them right?

David Brown - *Victory Capital - Chairman and CEO*

Yes, we use volatility in constructing the portfolio and that's one of the key drivers in how we construct the portfolio.

Jeremy Campbell - *Barclays - Analyst*

Okay, but so has interest in that sleeve picked up at all with volatility kind of coming back at all?

David Brown - *Victory Capital - Chairman and CEO*

It's been consistently good, so it hasn't spiked up or spiked down.

Jeremy Campbell - *Barclays - Analyst*

Okay. And then just kind of tagging one extra one here on the M&A side of things, along with everybody else. Just kind of wondering as you kind of look at the tools in your toolkit now that you have a public currency available to you, is there any sort of preference for kind of the financing structure of a potential deal and a go forward and maybe also any commentary you might have on kind of the balance between kind of the macro conditions of it might make a manager a little bit cheaper to acquire, but at the same time your public currency may have pulled back during that same time horizon as well?

Terry Sullivan - *Victory Capital - CFO*

Yes, it's Terry. I think Jeremy the real key for us in what we're laser focused on is shareholder value creation when we approach the M&A market. And as Dave mentioned earlier, it's a comprehensive approach that we take in evaluating and the metrics that we use, so it's both strategic and financial metrics that we look at that need to be compelling for us to move forward.

And I think in terms of the strategy for financing particular M&A situations, it's going to be case by case. We've got the tools and the toolkit that we need and when we evaluate strategically and financially what's compelling the financing strategy will follow that overall thesis, if you will. So I think -- and you got to keep in mind the value proposition that we have relative to what Dave talked about earlier, there's a lot of different things that we can bring to platforms to make them better which obviously results in we think shareholder value creation.

Operator

Thank you. Our next question comes from the line of Andrew Disdier of Sandler O'Neill.

Andrew Disdier - *Sandler O'Neill - Analyst*

So starting off on the new franchise front, just as far as -- would you be able to talk about some of the characteristics of the sellers where you're seeing the most interest? Meaning, are they individual proprietors or owners of the firm, are they private equity type owners or those asset managers kind of under a larger strategic umbrella with the more strategic firm focused on more core businesses?

David Brown - *Victory Capital - Chairman and CEO*

It's Dave. I think it's quite honestly a mix. We have -- the categories you've just gone through, I would tell you that we have had kind of conversations really with all types of firms, but the commonality what we're seeing is the desire for distribution access to approach distribution in the scaled way. The desire really to sit on an operating platform that's current and that will continue to be current, and really to be part of an investment-centric and employee-ownership culture.

And those things I think are the commonality and we're seeing that if you think about private-equity owned, big financial sponsor, or financial companies that own businesses, individual sole proprietors, really we've spoken to all of those and really it's the commonality of the points that I made.

Andrew Disdier - *Sandler O'Neill - Analyst*

Got it, yes. And then just this morning I saw some updates to kind of mutual fund pricing and gross expense ratios, wasn't able to get through all the detail, but could you just talk at a higher level focusing on some of the pricing within the various asset classes and strategies understanding the competitive dynamics within your Focus Asset Classes on a go forward basis?

David Brown - *Victory Capital - Chairman and CEO*

We like all other active managers have gone back and re-evaluated our pricing. In some areas, we've reduced pricing in mutual funds to be competitive. We've negotiated pricing with some of our institutional clients, that being said we're not seeing a material erosion of our pricing. If you look at our average fee for our business, it's high.

We think it's high for two reasons. One is, we know the products we have are value-added in portfolios and people are willing to pay for that. And two, we think we're in the right asset classes, as well where the pricing pressure isn't as high as some of the other asset classes.

Andrew Disdier - *Sandler O'Neill - Analyst*

Got it. Yes, I agree with your comments, didn't look like there were any significant moves. Thanks for taking the question.

Operator

Thank you. Our next question comes from the line of Alex Blostein of Goldman Sachs.

Sheriq Sumar - *Goldman Sachs - Analyst*

This is Sheriq filling in for Alex. Can you talk about the competitive landscape of the ETF offering and how well is the fee position with the other large scale players and any incremental color that you can provide on the distribution sides of your ETF products?

David Brown - *Victory Capital - Chairman and CEO*

So our ETFs we think are very differentiated. These are 30 to 45 basis point ETFs. As we stated in our prepared remarks, three of our ETFs have three-year track records, all five star ranked by Morningstar. We think the differentiation comes not only in the track record but our methodology and the way we're constructing the portfolios.

We have seen and we've launched a number of new products as well, a number of new ETFs. And we are really gaining traction with a larger distribution platforms with our ETFs and we're really excited about the opportunity when we look forward with our ETF business.

Sheriq Sumar - *Goldman Sachs - Analyst*

Thank you. And just one more from us, any plans for the dividends going forward? And just one question on financing, any long term target or leverage ratio that you have in mind that you feel comfortable about?

Terry Sullivan - *Victory Capital - CFO*

Sure, it's Terry. I'd say in terms of dividend, we don't have a dividend policy declared and that's really purposeful in the sense that as we look at capital management, we want our capital management policy to follow our growth strategy and so we feel that there's better opportunities for us to deploy capital in other areas, for example M&A or deleveraging which we did quite a bit of since our IPO and we think that's just right now a better proposition for shareholders and a better step to creating shareholder value.

And then on the second part, leverage, you could see that through some pro-activeness from a pay down perspective, we are at basically two times debt to EBITDA. That's a range that we're comfortable with and we'll evaluate capital deployment as we move forward.

Operator

Thank you. Our next question comes from the line of Chris Shutler of William Blair.

Chris Shutler - *William Blair - Analyst*

I wanted to come back to the M&A discussion once again. So you talked about a pretty broad $10 billion to $75 billion focus range. How should we think about -- I guess where in that range you're seeing more of the near to medium term opportunities and maybe also just talk about the pricing that you're seeing in the market?

Terry Sullivan - *Victory Capital - CFO*

Chris, maybe I'll take the pricing point first, I think generally what we're seeing right now is really a broad range of outcomes in the private markets and that's really if you think about it, it's reflective of I think the general environment that we're in. Growth prospects that targets really have, the momentum they have in their business and then positioning of their businesses.

So I think it's hard to narrow in on a range and I think as we approach the market that's something that were cognizant of. And I think, again, when you overlay the value proposition that we can bring to the table whether it's synergies, the ability to have a tax step up and then importantly plugging these platforms into our business that can generate a lot of potential growth for them. We think that there's a very compelling equation and that's why our pipeline is full and we're pretty active.

Chris Shutler - *William Blair - Analyst*

And in terms of the range, Terry, just kind of broad based or any sense more likely buys into that $10 billion to $75 billion or upper end?

Terry Sullivan - *Victory Capital - CFO*

Yes, I would say that as we look at the pipeline for the most part, spread across that range. I think that if you had to tilt it one way or the other, maybe it's on the lower end of that range from just an AUM standpoint and I think that's because we're seeing, and it ties back a little bit to the macro thesis that Dave mentioned earlier, we're seeing folks that are looking for better resource, better infrastructure to plug into to better their business and obviously our integrated multi-boutique is pretty attractive from that standpoint. And then when you layer in some of the other elements, autonomy etc., we feel that, that's where we're getting a lot of traction.

Chris Shutler - *William Blair - Analyst*

All right, it makes sense. And then just one follow up, on the incentive comp line, Terry, just can you talk about where that fell in the quarter as a percentage of pre-bonus EBITDA and where do you anticipate that percentage being for the year? Thanks a lot.

Terry Sullivan - *Victory Capital - CFO*

Yes, it's consistent with where we've basically said we would be, which is in the 30% area. And as we look at the performance of the business through the first quarter and as we look out with the momentum in the business, we see no reason to change that.

Operator

Thank you. This concludes our question and answer session today. I would like to turn the conference back over to David Brown for any closing remarks.

David Brown - *Victory Capital - Chairman and CEO*

Thank you for taking the time today to participate in our earnings call. If you have any additional questions, please don't hesitate to contact us. We will be participating in several upcoming conferences and look forward to seeing some of you there. Thank you for your interest in Victory Capital.

Operator

The conference has now concluded. Thank you for attending today's presentation, you may now disconnect.
