Victory Capital

June 12, 2018
10:35 AM EDT

Mike Cyprys: Okay. Great. Why don't we go ahead and get started. Good morning, everyone. Thanks for joining us. I'm Mike Cyprys, Morgan Stanley's brokers and asset managers analyst. And we're pleased to have with us Victory Capital. With us from Victory is David Brown – at the far end – Chairman and CEO of Victory Capital, and Terry Sullivan, CFO and Head of Strategy.

Victory is an integrated multi-affiliate asset manager with over $60 billion of assets under management across nine franchises, including RS and Sycamore, to name a few, and also a rapidly growing ETF franchise. Now, while Victory is new to the public market, they've actually been around for a while and they've been quite active, at least on the private side, for a number of years completing on a number of several highly accretive acquisitions.

Welcome. Thanks for joining us today.

David Brown: Thanks for having us.

Mike Cyprys: So, I thought maybe we'd start off, since you guys recently went public earlier this year, maybe if you could just remind us, give us a quick recap, in terms of who is Victory Capital, just for those who are new to the story in the room here.

David Brown: Sure. So, we're $60 – about $60.9 billion under management. A little over half of our business is institutional clients; a little under half is retail. We run a business model that we call the integrated multi-boutique, and what that is is just a little bit different than the other multi-boutiques that are out there. We have one company, one platform. So, we own 100% of these franchises. They're not separate companies. We have nine investment franchises and then one solutions kind of ETF platform, that we call VictoryShares.

Each one of our franchises, branded separately, logoed differently. They all run money totally independently and autonomously. So, they're generating their own unique alpha return stream.

They utilize one operating platform, and inclusive of that operating platform is a centralized sales and marketing platform. So, none of the franchises actually have franchise sales people. So, we have about 96 sales and marketing people, and they're selling all of the franchises. And we like to say on the front of their card they have Victory Capital; when they turn it over, they have all the different franchises there.

We have 10 offices in the U.S., three outside of the U.S. Most of the offices in the U.S. are investment-only offices. So, they're just the investment franchises. We're headquartered in Cleveland. We have about – total, about 285 employees; about 30% of that employee base is in Cleveland.

We have a lot of employee ownership, and what I mean by that is about one-third of our company is owned by our employees, and that employee ownership is spread over about 80% of our employee base. So, high employee ownership, and it's spread through a good number of our employee base.

And then we have a lot of money of our own money invested in our products. About $100 million is invested in our products from our 285 employees, all by choice. So, we're clients of ourselves and we're owners of the business and we have a long-term kind of mindset. Very unique, I think, in this space.

Mike Cyprys: Great. Thanks for the quick overview there. Now as we look across the landscape, there's a number of different multi-affiliate money managers out there. What would you say is unique about the Victory approach to the multi-affiliate business model? What's unique about Victory?

David Brown: So, let's maybe start with the operating platform. We have one company, one platform. And like I said before, that one company, one platform, everything is centralized other than the investment franchises and the investment process. So, think of the nine investment franchises, all branded, logoed franchises differently, but they're all utilizing a centralized platform. And what's very different is we have a centralized sales and marketing effort on both the retail retirement side and on the institutional side.

So, our concept, our model, really is to approach the largest distributors on the retail retirement side and on the institutional side when it comes to consultants in a very scaled way. So the franchises can spend all of their time – the investment professionals can spend all of their time managing money and not thinking about anything else. I think that's one unique aspect of our business. I think it positions us very nicely as we think about the distribution consolidation happening in the industry.

And then you think about the operating platform. We have one operating platform. That operating platform, when you think about reinvestment in technology and operations, we're making one investment, not nine different investments. We're making one investment. Part of the reason why when you look at our margins they're industry-leading for a business that's only $60.9 billion, we're able to kind of be very efficient when you think about our platform.

I think one other distinguishing point with us is we truly have a Victory culture. It's an ownership culture. I talked about the employee ownership. I talked about the employee investment in our products. It drives a certain behavior. It's the behavior that we think aligns us with clients and we think makes us a pretty good choice for clients when they're thinking about adding to their portfolios.

Mike Cyprys: Could we dive in just a little bit on that point, in terms of alignment of interest? As we look across a number of the other money managers that are out there, some have a revenue share, some have a profit share, some retain equity at the affiliates, some have equity at the parent. What would – can you talk a little bit more about your approach? What's differentiated? And what do you think are the positives or drawbacks of certain models versus others and the model that you have?

David Brown: So, thinking about alignment of incentives, first, we have the concept where we want to have our investment professionals spend 100% of their time managing money. We don't want them thinking about running a business. We think it takes away from the time that's needed from a mind share and actually from an actuality perspective of managing money.

So, revenue share is how we have compensated our investment franchises. It comes off of the top, it's a percentage of GAAP revenue, and it is mathematical. And it really allows the investment franchises to think about managing money every day. They're not conflicted when they think about if they're in different models where maybe there's expense allocations or maybe there's a thought about reinvestment. They're not conflicted of, "Am I going to invest for the future at the expense of today?" And there are many times that people are putting their own personal kind of situations ahead of maybe what the future might need from an investment perspective. We don't have those issues because we're compensating on revenue share. We think that's an important component to our structure.

We also think, on a compare and contrast, we also think that the distribution side is very unique and very additive, where they know that they have close to 100 people – the investment franchises have close to 100 people from a sales and marketing perspective going out and selling their products. In today's world where you need scale, you need relationships to make progress with some of the larger platforms, we think that's quite unique.

And then I'll go back to, like I said, the ownership side I think is pretty important.

Mike Cyprys: Great. And maybe we can shift gears and talk about M&A, a key part of the growth strategy. And we'll come back and talk about organic growth in a moment. But just if you could provide some color around your acquisition strategy and views on potential targets and thoughts on potential bolt-on versus transformative M&A. What's sort of the appetite there and the strategy?

Terry Sullivan: I think, as we've talked about, we have multiple growth levers, and M&A is an important part of our growth strategy. And we feel that way, one, because we do think that the market is constructive. There's a lot of macro trends that we believe are favoring M&A for some of the firms that are in our strike zone.

We also think that as we look at our integrated multi-boutique model and some of the capabilities we have and our value proposition to targets, we just think that it resonates. So, it's the right growth strategy for us, maybe not for everyone, but for certainly for us.

In terms of what we're looking for, I would say generally speaking we're attribute-driven. We've repositioned this business over the last five years deliberately into focused asset classes that we think we can win in and we think that the market has positive growth trajectories for.

And so, we extrapolate that thesis into M&A. And so, we're looking for asset classes that, first of all, fit into our distribution model, we feel are things that we can successfully sell with our clients as far as distribution capabilities. We like to look at types of products and strategies that are alpha-generative, one, because that makes them more attractive and also we think it can justify their fees.

And then, importantly, and really the overlay for all of this is that there needs to be a very compelling cultural fit, and we're also looking for integration. And there can be degrees of integration. There are some targets that we're looking at that we will of course leave alone from a product and investment autonomy standpoint but can very much onboard operationally. There's other capabilities that maybe there's a less degree of integration but there's a lot of upside and success that we can bring in distribution, for example.

Mike Cyprys: Great. And maybe we could talk a little bit about – sorry. Were you going to add something?

David Brown: What I would add on the M&A side, we've got a set of products today. We have about close to 80% of our assets are in these focus asset classes, which is U.S. mid, U.S. small, international/global, and then kind of the solutions ETFs. And those are really, if you think about the asset classes, those are our growth drivers of today, and I think they will grow as we move into the future.

But one of the things that we're going to use M&A as the tool is we're going to go out and acquire businesses that have asset classes when you look out three to five years and look about what's going to happen in the industry where if you think about beta and you think about alpha there is going to be probably a clear distinction on what's beta and will people pay for that – probably won't pay active management fees – and then what's alpha – and people will pay active management fees. And alpha is probably going to be categorized as solutions-based, things that are either capacity constrained or the asset classes are inefficient or there's ways to generate income, but there are things that you're actively doing. We want to – we're going to use our M&A capability that we've proven we've been able to do over the years to acquire more of these products, more of these products in these asset classes.

So, you think about the transition from where we are today to where we're going, the M&A side and the M&A capability will get us the products when we think about the future products of the industry, will allow us to acquire additional products from what we have today to be products of the future.

Mike Cyprys: Great. And you've mentioned more recently that the M&A pipeline is pretty full. It's been pretty high, I guess, relative to where it's been, you've said. But at the same time you recently announced a buyback plan. So, I guess that might suggest that maybe there's no imminent deal. How are you thinking about the trade-offs there? And what are the drivers that are driving this pipeline to be pretty strong?

Terry Sullivan: I guess I'd first take the question around the buyback. A couple of soundbites on the buyback. First of all, we think that as we evaluated the potential for implementing the program, we thought that it demonstrated some proactiveness and thoughtfulness around capital strategy and do believe that it's a strong signal, a good endorsement from management and the board that we think the stock is undervalued. So, that's the first point.

Secondly, to be 100% clear, this is in no way a signal that we're prioritizing buybacks over M&A or any indication that there's softness in that pipeline. We're as busy as we've even been. And if you think about just the size of the buyback – up to $15 million – the technicalities around executing a buyback such that that's going to take quarters to do, it's very manageable from a cash management standpoint, but we think impactful.

So, when you put that all together, we are managing our capital strategy in a way that just is geared towards driving shareholder value, and we think that M&A, deleveraging, and now buybacks are all in line with driving shareholder value.

Mike Cyprys: Great. Maybe we could shift gears and talk about organic growth, the other avenue there for growth. Can you talk just a little bit about the strategy behind organic growth? How are you planning to source and attract flows?

David Brown: So, when you think about our organic growers, I talked about the focused asset classes. And I think about U.S. mid, U.S. small, international/global, and our ETF business, VictoryShares. Those asset classes will drive the organic growth. We have a very balanced distribution system, 96 people. We have on the institutional side relationships with the largest consultants. If you take the top 10 consultants in the U.S., I think we have business with eight of them, and I think of the eight we have – seven of the eight have multiple franchises. So, we're very well connected on the institutional side. And I think if you go down to the top 25, I think the numbers are we do business with 20 of the top 25. So, we have the relationships on the institutional side.

And then you look on the retail and retirement side, we are deep into the largest platforms in the U.S. So, Edward Jones I think is our largest relationship, but Morgan Stanley, UBS, Merrill Lynch, Raymond James, these are all platforms where we have multiple franchises, multiple products on their focus or recommended list. In fact, I think with Edward Jones we have seven of our nine franchises on the recommended or model list.

So, we've got great distribution connection. But you need the right products and obviously you need really good investment performance. We have excellent investment performance across the board. I think if you looked at our first quarter statistics, as good as anybody in the industry from a one-, three-, five- perspective. And from an outperformance of the benchmark, an outperformance when you think about the number of strategies and just from an AUM perspective. So, we have very good performance.

Good performance, good distribution, and in the right asset classes is the formula for organic growth. First quarter, we did not have organic growth, as most of you know if you listened to our earnings call. Some of that was due to some rebalancing that clients did and other, I'd say, other activities that we think were probably one-off. What we've said and what we believe is when you look at our business over a longer period of time, you'll see the organic growth or you'll see market or market-plus from an organic growth side. We feel really good about that. And then longer term, I mentioned earlier about using M&A as a tool to gather other products to continue on with the organic growth.

Mike Cyprys: And if we just dive in a little bit on the focused asset classes, I guess, why do you think those are the right asset classes? And where are you seeing the flows today within the focus list?

David Brown: So, those focus asset classes have a few different – each of them are different, but there's a few common attributes in each asset class. One is capacity constraint. So, if you think about U.S. small cap, U.S. mid cap, emerging market small cap, or international small cap, there's typically more demand than there is capacity. So, you have capacity-constrained products, which bodes well for growth.

The actual investing asset class, it's not as efficient as, like, a U.S. large cap. So, there is an ability, if you're good, where active can outperform, where people are still willing to pay an active management fee for a manager that's good. You see less and less of that on the U.S. large cap side. But when you start to go down in cap size and start to go international/global, you're seeing where these are inefficient asset classes and active management is still growing there.

Our ETF business, VictoryShares, we bought that business in 2015. It had about $190 million in AUM, and we're approaching $3 billion today, and growing. A lot of that growth actually came pre our three-year track record in some of the ETFs. We have a – three of our ETFs are five-star rated by Morningstar. And the way we're approaching ETFs is quite unique. We are not an ETF provider going against just the BlackRock's, the State Street's, where it's one basis point. Our ETFs average 30 to 45 basis points. These are somewhere between passive and active; we call it a hybrid.

So, there are really solutions-based. They're off of a few different – they're rules-based, but they're really solving issues in the portfolio, and there's a few different models that we're using that we're applying to different benchmarks. And they have grown quite significantly, and we think that's going to continue, going forward. There's tailwinds in that part of the market, and we've actually gained significant market share, even with those tailwinds. And we're seeing growth there.

Specifically, our international and global franchises – Trivalent, Sophus – are growing. Sycamore, our largest franchise, which is soft-closed, still has the ability for current clients to add more, and they are adding more to those franchises. We're seeing nice growth in our RS small-growth franchise. So, we see a good number of franchises where we're seeing some of the growth. And then some of the areas where we're flat, I think clients haven't added but they're happy with their client experience because of the good investment performance. And when you put that together, that's a good formula for organic growth.

Mike Cyprys: Great. We'll open it up for the audience in just a moment. So, get your questions ready. Just on capacity, an area that you touched upon, how do you manage around that? And where are we sort of seeing capacity constraints today across your strategies?

David Brown: So, first, how we manage capacity, that's really an investment decision. We allow the CIOs of each of the franchises to determine their capacity. It really comes down to the ability at the highest level to manage money the way they managed it when the product was small; a simple way of putting it.

But they're looking at trading, they're looking at getting in and out of stocks, they're looking at how their client servicing and what the load is on the research side. But they determine that. There is no mathematical or quantitative formula for that. It's really determined by each CIO.

We have some of our strategies are soft-closed. Sycamore's U.S. small cap strategy is soft-closed. Their mid-cap strategy, which is called Established Value on the mutual fund side, is soft-closed. What that means is it's not open to new platforms, but it is still open to investors, current investors. So, for example, our sub-adviser client wants to add more and we've kind of earmarked the capacity, they can still add more. So, you still have some flows coming in there. Integrity's small cap product is closed.

Other than those three, everything else is kind of fully open. We have a page on our earnings release which shows our focused asset classes and the investment franchises within those asset classes. I believe the number of open capacity there is about $116 billion, if I remember correctly. So, we've a lot of open capacity in the right asset classes, with good investment performance.

Mike Cyprys: Great. Why don't we open it up to the audience to see if there's any questions in the room. We have a microphone going around.

There's a question over there, in the back.

Unidentified Audience Member: Good morning. You've talked about the breadth and the quality of the pipeline for acquisitions. Could you narrow that a little bit more to kind of meaningful EBITDA, possibility getting done in some discreet time frame, the next six months, the next 12 months, how that sort of smaller part of the pipeline looks?

David Brown: So, I guess, first, from an acquisition perspective, we're balancing speed and kind of quality. We've been extremely active if you go back to July of '13 when we did our MBO. We've done an MBO, three acquisitions, a minority investment, and an IPO in under five years. So, we've been busy, and we work with urgency.

A big pipeline, but we're balancing doing the right deal. So, we're not going to lose our discipline or our focus and just do a deal to do a deal. I think that that's a mistake. But we also think that we have a really healthy pipeline and that we think in the shorter term that we will be able to get a deal done.

The deals that we're focused on are going to be meaningful to our platform. And meaningful doesn't have to necessarily be size, but I don't want to direct you away from that we're not interested in larger deals. But if you look at the history of our acquisitions, we've done a very small deal in Compass, which was our ETF business. That has grown into something significant and will be a grower and a driver of organic growth. So, it's very meaningful; it got us into the ETF business. That was very strategic. We would look at deals like that, but it would have to be extremely strategic to do a small deal.

Going up the size chain, we have done deals that have doubled the size of our business. We would still do deals that would double the size of our business, but that would have to be a deal that we felt very confident in and that was very value-added.

A lot of our pipeline is in that middle. Where it's meaningful, it's meaningful from an EBITDA perspective, from an AUM perspective, definitely from a product perspective. We talked about – Terry talked about having products that are really on that alpha side, talked about products that would help us grow in the future. We care very much about that.

So, I can't tell you that we've narrowed in on a certain AUM size and I can't tell you exactly when we're going to do a deal, but I can tell you we're highly confident in this strategy, of which M&A is a huge part of our strategy. But we're going to remain pretty disciplined and focused, as well.

Mike Cyprys: Great. Do we have any other questions? Over here?

Unidentified Audience Member: How about looking outside the U.S.? I think you mentioned you had a couple of offices outside the U.S. Would you look to expand in those areas? Or are those just investment offices, primarily?

David Brown: So, today, we have offices in Hong Kong, Singapore, and London. Those are investment-only offices. We have looked and are looking outside of the U.S. We think having a manufacturer outside of the U.S. and also getting distribution outside of the U.S. Today, our distribution outside of the U.S. is concentrated in Canada, Japan, and then sprinkled around the world just kind of opportunistically but not a kind of concerted effort like we have in Japan or in Canada. That's within scope for us, is doing something outside of the U.S.

Mike Cyprys: Questions in the room?

Maybe we could talk a little bit about capital allocation policy, how you're thinking about allocating cash between M&A and delevering further versus the buybacks that you had touched upon earlier? But I guess now it's a delevering point in there. How do you think about that mix and the right level of leverage at which you want to run the business?

Terry Sullivan: Sure. I think, as we talked about before, our capital management strategy is very in line with our growth strategy. And so, our uses of cash right now are to focus on M&A, delever, or buy back shares. And I would say, qualitatively, think of M&A for us as strategic and high-priority, and we do think that given what we bring to the table for targets that is probably the best use of – best way to create shareholder value.

I'd say deleveraging, which we've done a fair bit of over the last year, really – even since our IPO, we've brought our debt down about 15% – that is a focus. It's a priority, on the margin perhaps tactical. We'll evaluate our cash position frequently and then make paydowns as we have relative to other uses.

And then as we discussed earlier, the buybacks are opportunistic, and we'll target when we feel there's good value.

Mike Cyprys: Questions in the room? Maybe just circling back, Dave, on the ETF business, how are you thinking about growing that? Do you need an acquisition to get that to scale in your view? Can you do it organically? How are you thinking about the levers there?

David Brown: So, organically, we've been pretty successful. We're really just pushing the ETFs through our distribution network now. It's a relatively new business for us. So, we're going to have very nice organic growth as we look out. It's been very consistent, and we see it getting approved on a number of the major platforms.

One thing I should say about our distribution on the ETF side is we don't have an ETF-only distribution force. Many do. We've actually consolidated our distribution force where they sell ETFs and mutual funds. And we compensate exactly the same. So, at the point of sale, we're really able to go to an adviser and really think about a solution, and we're not biased on what we're selling them.

So, we think the ETF side can grow very nicely organically. We have looked at a number of ETF businesses, but as with a lot of successful parts of any industry when there is a part of success, people typically start businesses and they want to get into that. There are not a lot of quality ETF, kind of independent ETF businesses left. And so, of course we would think about doing an ETF acquisition, but I will tell you they are few and far between of many high-quality ones.

Mike Cyprys: Great. We have, like, a minute left, just for any final questions in the room?

Maybe just staying on the ETF point, prospective views on how you think these ETFs would perform in different market cycles, given the kind of differentiated approach that you have with these more rules-based strategies?

David Brown: So, during the periods of volatility that we've experienced over the last couple of months, our ETFs have performed very consistently. We don't think – given that it's a rules-based strategy, we don't think that it will perform in a way that isn't expected, is what I would say. So, we know one of our strategies really equal-weights. So, we know the days that Apple and Facebook and Amazon do well, we know we could potentially underperform there. It's pretty predictive. And each one of the ETFs that we have really is a solve for a portfolio. So, many of the buyers are looking at, "Okay, I know how this is going to perform in this market, in this market, in this market." And we've been pretty consistent on how it's performed in a lot of different markets.

Mike Cyprys: Great. Why don't we leave it there. Please join me in thanking Terry and Dave. Thank you.