

Virtus Investment Partners, Inc. NasdaqGS:VRTS

FQ2 2023 Earnings Call Transcripts

Friday, July 28, 2023 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2023-			-FQ3 2023-	-FY 2023-	-FY 2024-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	5.88	5.43	▼ (7.81 %)	6.26	22.84	NA
Revenue (mm)	198.56	190.56	▼ (4.03 %)	206.52	792.31	NA

Currency: USD

Consensus as of Jul-28-2023 1:27 PM GMT

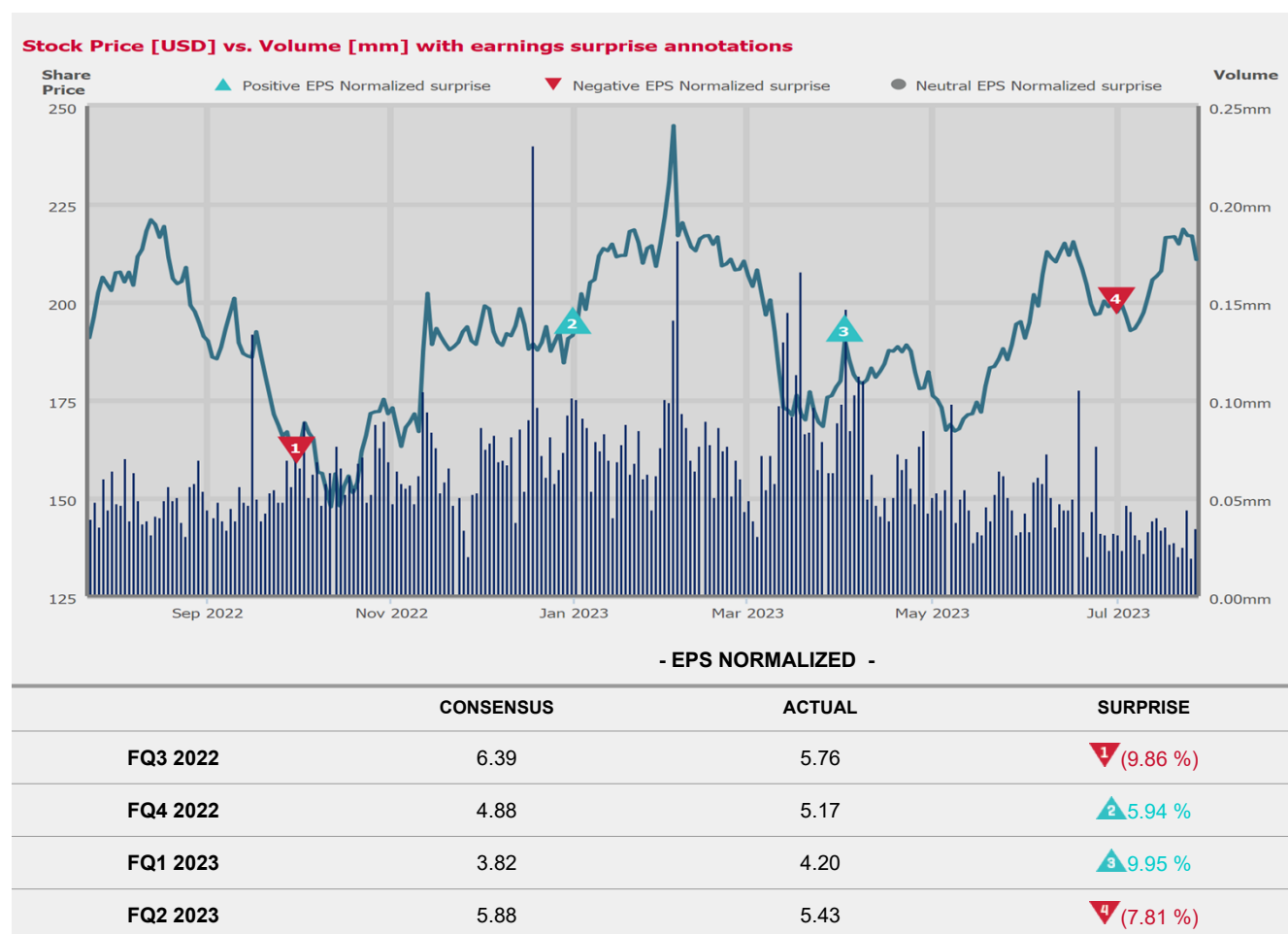


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Call Participants

EXECUTIVES

George Robert Aylward
President, CEO & Director

Michael Aaron Angerthal
Executive VP, CFO & Treasurer

Sean Rourke
Vice President of Investor Relations

ANALYSTS

Michael J. Cyprys
Morgan Stanley, Research Division

Sumeet Mody
Piper Sandler & Co., Research Division

Presentation

Operator

Good morning. My name is Tawanda, and I will be your conference operator today. I would like to welcome everyone to the Virtus Investment Partners' Quarterly Conference Call.

The slide presentation for this call is available in the Investor Relations section of the Virtus website, www.virtus.com. This call is being recorded and will be available for replay on the Virtus website. [Operator Instructions]

I will now turn the conference over to your host, Sean Rourke. Sir, you may begin.

Sean Rourke

Vice President of Investor Relations

Thank you, and good morning, everyone. On behalf of Virtus Investment Partners, I'd like to welcome you to the discussion of our operating and financial results for the second quarter of 2023.

Our speakers today are George Aylward, President and CEO; and Mike Angerthal, Chief Financial Officer. Following the prepared remarks, we'll have a Q&A period.

Before we begin, please note the disclosures on Page 2 of the slide presentation. Certain matters discussed on this call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, and as such, are subject to known and unknown risks and uncertainties, including, but not limited to, those factors set forth in today's news release and discussed in our SEC filings. These risks and uncertainties may cause actual results to differ materially from those discussed in the statements.

In addition to results presented on a GAAP basis, we use certain non-GAAP measures to evaluate our financial results. Our non-GAAP financial measures are not substitutes for GAAP financial results and should be read in conjunction with the GAAP results. Reconciliations of these non-GAAP financial measures to the applicable GAAP measures are included in today's news release and financial supplement, which are available on our website.

Now I'd like to turn the call over to George. George?

George Robert Aylward

President, CEO & Director

Thank you, Sean. Good morning, everyone. I'll start with an overview of the results we reported earlier today before turning it over to Mike to provide more detail.

Key highlights of the second quarter included a meaningful improvement in net flows to breakeven, strong institutional sales and flows across affiliates, strategies and geographies, positive net flows in global funds, private client and ETFs, attractive investment performance, both long term and year-to-date across strategies, continued investment in the diversification of the business with the addition of the new affiliate, and we maintained a well-positioned balance sheet and modest net leverage.

Turning now to a review of the results. Total assets under management increased 9% to \$168 billion due to the addition of AlphaSimplex and market appreciation. Sales increased 22% sequentially to \$7.6 billion due to continued momentum in our institutional business. On the retail side, sales declined primarily in domestic equity, though global equity sales increased significantly. Retail separate account sales were essentially unchanged from the prior quarter. Our net flows are breakeven, a significant improvement from the prior quarter due to institutional. By product, institutional net flows of \$2.2 billion improved from modest net outflows in the first quarter with strong sales and net flows across affiliates, strategies and geographies.

Over the past 4 quarters, institutional has generated 5% organic growth in a challenging environment. Fund net outflows of \$2.1 billion compared with \$1.8 billion in the first quarter as an improvement in fixed income strategies was more than offset by lower equity flows consistent with the industry. Within equities, both global equity and domestics mid-cap generated positive net flows. Retail separate accounts continue to be at relatively breakeven levels.

In terms of what we're seeing in July, our institutional pipeline remains strong with one but not funded mandates exceeding known redemptions, and we see opportunities in the CLO market. For open-end funds, trends have improved meaningfully including continued positive flows in our global funds as well as our ETFs.

Our second quarter financial results reflected the impact of market [appreciation] on AUM levels particularly near the end of the quarter as well as the addition of a new affiliate at the beginning of the quarter. The operating margin was 32.3%, up sequentially from 26.8%, primarily due to the impact of seasonal employment expenses in the prior quarter. Earnings per share, as adjusted, of \$5.43 increased from \$4.20 in the first quarter. Excluding prior quarter seasonal items, earnings per share as adjusted increased 2% sequentially.

Turning now to capital. Our balanced and prudent approach to capital management supported by significant financial flexibility, has positioned us to invest in growth initiatives, such as strategically adding affiliated managers, while returning capital to shareholders and maintaining appropriate levels of working capital and leverage. During the quarter, we closed on AlphaSimplex with existing financial resources, including utilization of our revolving credit facility.

We also repurchased approximately 52,000 shares for \$10 million. And in June, we repaid \$10 million of the credit facility. We ended the quarter with modest net debt positioning us to continue to be flexible in prioritizing capital allocation and circumstances warrant, including paying down the credit facility this year and repurchasing shares, which are key priorities.

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

Michael Aaron Angerthal
Executive VP, CFO & Treasurer

Thank you, George. Good morning, everyone.

Starting with our results on Slide 7, assets under management. At June 30, assets under management were \$168.3 billion, up 9% from \$154.8 billion at March 31. The growth reflected the addition of \$7.8 billion of assets from AlphaSimplex and \$6.3 billion from favorable market performance. Average assets in the quarter increased 7% to \$163 billion, and ending assets under management were 3% higher than the quarter's average. Our assets under management remained diversified by asset class and product type. We've continued to expand our investment capabilities in less correlated and alternative strategies, which now represent 11% of AUM, up from 7% prior to the acquisition of AlphaSimplex.

Fixed income and multi-asset were each relatively unchanged sequentially at 23% and 12% of AUM, respectively, though each increased during the quarter. Notably, institutional now represents 37% of total AUM, up from 32% a year ago and non-U.S. clients are 17%, up from 15% last year. We also continue to have compelling long-term relative investment performance across products and strategies. As of June 30, approximately 69% of institutional assets and 89% of retail separate account assets were outperforming their benchmarks over 5 years.

In addition, approximately 62% of rated fund assets had 4 or 5 stars, up from 43% last quarter and 87% were in 3, 4 or 5-star funds. We had 38 funds that were rated 4 or 5 stars, including 11 with AUM of \$1 billion or more, up from 7 last quarter. On a 5-year basis, 77% of our rated fund AUM was outperforming the median performance of their peer groups. I would also note that our managers performed well year-to-date in volatile markets with 67% and 86% of institutional and separate account AUM, respectively, beating benchmarks for the period and 70% of mutual funds AUM, outperforming the medium performance of the peer group.

Turning to Slide 8, asset flows. Total sales were \$7.6 billion, up 22% from \$6.2 billion last quarter due to strong institutional sales. By product, institutional sales were \$3.7 billion, nearly double the prior quarter level due to a new larger low fee fixed income mandate and several significant contributions to existing accounts. Fund sales of \$2.6 billion declined from \$3 billion as higher global equity sales were more than offset by lower sales and other strategies, particularly domestic equity. Retail separate account sales of \$1.3 billion were largely unchanged sequentially.

Total net flows were breakeven with the improvement from \$1.9 billion of net outflows in the prior quarter due to institutional. Reviewing by product. Institutional net inflows of \$2.2 billion increased from modest net outflows in the prior quarter with strong net flows across strategies. Institutional net inflows also continued to be well diversified across affiliates. For open-end funds, net outflows were at similar levels to the prior quarter was \$2.1 billion compared with \$1.8 billion.

Within open-end funds, both global funds and ETFs had positive net flows. Global funds, which had \$4.2 billion of AUM at June 30, had positive flows in both the global large-cap growth and small-cap focused strategies. And while fixed income funds remained in net outflows, nearly all fixed income strategies had a sequential improvement. In retail separate accounts, net outflows of \$0.1 billion compared with net inflows of \$0.1 billion in the first quarter as continued positive net flows in private client were offset by modest intermediary sold net outflows.

Turning to Slide 9. Investment management fees, as adjusted, of \$171.1 million increased \$13.5 million or 9%, reflecting the 7% sequential increase in average assets under management, a modestly higher average fee rate and an additional day in the quarter. The average fee rate of 42.2 basis points increased by 0.2 basis points from 42 in the prior quarter. The fee rate was unfavorably impacted by 0.3 basis points due to a discrete transitional expense item related to the AlphaSimplex funds that will not recur.

The sequential increase in the average fee rate largely reflected the addition of AlphaSimplex's higher fee rate alternative strategies, which was mostly offset by the mix shift given the relative growth of the institutional business. Performance fees in the quarter of \$0.3 million compared with \$0.2 million in the first quarter. Looking forward, we believe our range of 42 to 44 basis points remains appropriate for modeling purposes, which, as always, will be impacted by markets and the mix of assets.

Slide 10 shows the 5-quarter trend in employment expenses. Total employment expenses as adjusted of \$95.8 million decreased 3% sequentially, reflecting \$11.4 million of seasonal items in the prior quarter, largely offset by the addition of AlphaSimplex. As a percentage of revenues, employment expenses were 50.3%, up from a seasonally adjusted 49.3% in the first quarter due to the addition of AlphaSimplex. For the third quarter, given beginning AUM levels and continued market appreciation, it is reasonable to expect that employment expenses as a percentage of revenues will be toward the lower end of our 49% to 51% range. As always, it will be highly variable based on market performance, in particular as well as profits and sales.

Turning to Slide 11. Other operating expenses, as adjusted, were \$31.7 million up \$1.9 million or 7% from the first quarter. The sequential increase was largely due to the addition of AlphaSimplex as well as the \$0.9 million of annual grants to the Board of Directors. Excluding AlphaSimplex, other operating expenses declined 3% over the prior year period reflecting continued close management of all discretionary expenditures. Looking ahead, we believe other operating expenses, as adjusted, will be in a quarterly range of \$31 million to \$33 million down modestly from the previous range.

Slide 12 illustrates the trend in earnings. Operating income as adjusted of \$61.6 million increased by \$14.2 million or 30% sequentially due to the prior quarter seasonal employment items and a higher average assets under management. Normalizing for the seasonal items, operating income increased 5%. The operating margin as adjusted of 32.3% compared with 26.8% in the first quarter or 33.2% normalizing for the seasonal items.

Other income expense as adjusted increased by \$0.7 million due to higher unrealized losses on investments. Total net interest income expense increased by \$1.1 million, reflecting the higher gross debt and higher variable interest rates. Net income as adjusted of \$5.43 per diluted share increased 29% from \$4.20 in the first quarter. Second quarter net income per diluted share included a \$0.16 per share reduction from the discrete item.

Regarding GAAP results. Net income per share of \$4.10 compared with \$5.21 per share in the first quarter and included \$0.31 of net acquisition-related expenses, including transaction costs, partially offset by fair value adjustments to contingent consideration, \$0.30 of net realized and unrealized losses on investments and \$0.21 of favorable fair value adjustments to affiliate noncontrolling interests.

Slide 13 shows the trend of our capital liquidity and select balance sheet items. On April 1, we completed our acquisition of AlphaSimplex for \$113 million in cash, including \$50 million drawn on our revolving credit facility. In June, we repaid \$10 million of the revolver and ended the quarter with net debt of \$99 million, representing net leverage of 0.4x EBITDA. We continue to expect to repay the \$40 million outstanding on the revolver over the course of the year.

Largely, as a result of the transaction closing payment, working capital declined to \$124 million at June 30 from \$184 million at March 31. In addition, during the quarter, we repurchased 51,840 shares for \$10 million. We continue to have a strong balance sheet with more than adequate levels of working capital and modest leverage, providing meaningful financial flexibility.

With that, let me turn the call back over to George. George?

George Robert Aylward
President, CEO & Director

Thanks, Mike. We will now take your questions. Towanda, would you please open up the lines?

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Sumeet Mody with Piper Sandler.

Sumeet Mody

Piper Sandler & Co., Research Division

I wanted to start on the fee rate. AUM was up a bit sequentially, still came in at the -- the fee rate on the AUM was up a bit sequentially here. Just wondering, with the large institutional inflows, maybe offset a bit by AlphaSimplex, can you unpack the dynamics around what drove the level here in the second quarter kind of net-net of any of those onetimers?

George Robert Aylward

President, CEO & Director

Sure. And for the fee rate, again, the geography and the underlying changes in either AUM mix strategies that are either redeeming or pulling in assets can create a little movement within the components and the subcomponents, particularly in a quarter like last quarter, where you kind of had a rising market and then you had flows going in at different fee rate differentials.

Mike, do you want to go through the pieces?

Michael Aaron Angerthal

Executive VP, CFO & Treasurer

Yes. I think as we look at the fee rate, providing it by product, the mix shift certainly impacts the overall fee rate. We look at it by product, it's stayed in a relatively tight range, even increasing in the quarter, as you noted, from AlphaSimplex. And institutional has become a bigger part of the business. We noted it's now 37% of the business, up from 32% a year ago. So you're seeing that impact the overall fee rate. I think adjusting for the discrete item, we ticked up from 42 to 42.5 and reiterated the range, but that range will be impacted by the mix shift and by the market action. So we'll continue to update accordingly. But from our standpoint, the fee rate has been resilient, has been resilient on each of the product categories, and we're impacted more again by markets and the mix shift.

Sumeet Mody

Piper Sandler & Co., Research Division

Got it. And then nice to see the institutional wins in the quarter. Just wondering if you can get an update on that pipeline for July to date? And then how that demand for kind of institutional and SMA funds have kind of trended there?

George Robert Aylward

President, CEO & Director

Yes. On the institutional side, we continue to be pleased with the strength of the pipeline. And as we speak to strength, generally, we prefer to see is diversity in terms of either strategies, affiliates as well as geographies, and I think we highlighted that in our comments. So we continue to see that as a nice pipeline. Again, it's a very lumpy business. So of course, there will be different timing aspects of some of the mandates versus the others. But it is nice to see not only some of the fixed income strategies being attractive, but then that are at one fee level, but as well as some of the growth equity side, which is slightly different, which sort of then lends to the changes in our fee rate, but we continue to be pleased with what that looks like and how diverse it is.

Sumeet Mody

Piper Sandler & Co., Research Division

Great. And then last one for me here. Just on the fixed income side of the business. Just looking at retail, outflows have been pretty consistent since rates started increasing last year. They've been slowing a little bit in recent months. So with the range of strategies that you guys have across fixed income, can you talk about your expectations for the demand kind of across retail and institutional, given the mix? And then maybe you can add some commentary on that market neutral merger fund as well within alternatives. It's a context of the environment.

George Robert Aylward

President, CEO & Director

Well, on the second piece, I think the macro view on mergers and acquisitions is not the most favorable that it's been. So that's going to have an impact on how people look at strategies like that. So again, with some of the headlines and some of the transactions, I think, unfortunately, some retail investors are incorrectly being a little more negative on those types of strategies than they should be. Going back to fixed income, our view is that there really should be a lot more of an interest in some of those strategies. We've seen some increases in some of our strategies, improvements from where they were, but not to the levels where we need to be. But the hope would be, as people start getting a little more clarity on the rates going forward, they'll start taking advantage of some different strategies than previously what they've been doing.

Operator

Our next question comes from the line of Michael Cyprys with Morgan Stanley.

Michael J. Cyprys
Morgan Stanley, Research Division

Maybe coming back to some of the commentary on the institutional pipeline. I guess my follow-up question here would just be how do you sort of characterize the fee rate on the pipeline compared to the 31 basis points or so institutional fee overall? And I think you mentioned that you had a low fee institutional mandate fund in the quarter. Maybe you can help quantify is that single-digit sort of [ZIP code?] And what sort of strategy that was in the quarter?

George Robert Aylward
President, CEO & Director

Yes. And on that, I think Mike referred to it as lower fee. So again, in the mix in terms of what we see going forward, I think we've -- in the comments, basically indicated that we still feel very comfortable with the range of the 42 to 44, which, again, given the mix could move up and down a little bit. But to some of my earlier comments, sometimes we will see some larger mandates because of their size or their strategy such as investment grade will be lower than other fees. And then other strategies, more sophisticated or high conviction equity strategies will have higher. So we kind of look at that collectively in terms of the bucket because you'll be having some coming in and going out.

So that one account did not impact the guidance that we're giving in terms of what the reasonable fee rate is because there'll be -- there are a lot of moving parts. And then including on the underlying assets, which for institutional or mix of fixed income as well as equity, the relative sizes based upon market appreciation will also change.

Anything else, Mike, you'd add?

Michael Aaron Angerthal
Executive VP, CFO & Treasurer

I think, George, you summed that up pretty well. I think and specifically, Michael, looking at the pipeline, it does support the current quarter's level of institutional just above that 31.5 fee rate level. It has -- given the breadth of it, it has fixed income as well as equity. It has a breadth across geographies as well. And looking at the new business that was also part of the strength in institutional in the current quarter, excluding this larger mandate, you're actually above the fee rate. So you've got some puts, some takes. But when we look at the breadth of the business, I think the current quarter's level is appropriate for modeling and supports, again, some of the strength that we're seeing on that institutional side.

Michael J. Cyprys
Morgan Stanley, Research Division

Great. And just maybe you could update us on how you're thinking about capital allocation here and M&A on the capital allocation side. I hear you on paying down the \$40 million revolver it sounds like by the end of the year. Just how are you thinking about buybacks as well into the end of the year as well as M&A? How much time are you spending on that these days? And maybe you can give us an update on what sort of properties you're seeing out there and where you might have interest from here?

George Robert Aylward
President, CEO & Director

Sure. So in terms of the capital priority, so in the comments kind of indicated, we do believe that it's appropriate to pay down what we drew on the credit facility. So our goal, and I think we commented on last quarter as well as in our comments earlier today, by the end of the year, bringing that down. And again, given our current low level of leverage and our cash flow generation, we can certainly

do that, and we continue to believe that repurchasing our shares in view of the current valuation is a great use of our capital. So we purchased -- we used \$10 million last year, and we continue to see that as an opportunity.

In terms of M&A, continue to be as active as we've always been, which really refers to the amount of activity and work that we're doing sometimes which turn into transactions and sometimes don't. We continue to see that to be an area of opportunity for us. Again, we always do try to prioritize our organic growth, but we continue to consider inorganic opportunities.

So I do think there continues to be a lot of activity going on in the M&A market, in our sector. We continue to evaluate things that we think would be strategically additive to the business in terms of further diversification, particularly as it relates to clients and geographies as well as, as you've seen in our last 2 transactions, we're also kind of focused towards less correlated investment strategies from the traditional long-only equity and fixed where we always had a pretty good array of that.

So we'll continue to evaluate that. But again, we'll continue to take the cash that we generate and make sure that we have a comfortable level of leverage as well as returning capital to shareholders through both our repurchases as well as our dividend. And as you know, we've increased our dividend annually over the last few years.

Mike, anything else you'd add to that?

Michael Aaron Angerthal
Executive VP, CFO & Treasurer

Yes. I think -- George, the other thing I'd reiterate on what you indicated in part of the prepared remarks on capital, we do continue to invest in the business. George alluded to the fact that we're seeing CLO opportunities, and we would use capital to support the teams on CLO issuance, which is something that the current market environment seems that may be conducive. So we're balancing all the priorities George alluded to as well as continuing to support our affiliates growth.

Michael J. Cyprys
Morgan Stanley, Research Division

Great. And just a final question for me. You guys have done a number of acquisitions over the past couple of years, and a number of them have also had these contingent payments or earn-outs. So I was hoping you might be able to remind us on what's still to come through from a cash standpoint over the next couple of years that could be paid out?

Michael Aaron Angerthal
Executive VP, CFO & Treasurer

Yes. And we have the contingent consideration that we look at each quarter on the balance sheet and you may recall that each first quarter, we have a payment of the revenue participation payments that have been in the \$25 million range over the first 2 periods. This would be the third period coming up. And we had talked about the bulk of that being over a 5-year period, then there's also some longer tailed contingent consideration related to Westchester Capital, which would be out years 4 and 5 post that transaction, which closed in 2021. So that's 2 to 3 years from now, so more imminent over the next 2 years or the first quarter of each year related to the revenue participation payments.

Operator

Ladies and gentlemen, this concludes our question-and-answer session. I would now like to turn the conference back over to Mr. Aylward.

George Robert Aylward
President, CEO & Director

Great. Thank you so much. And I want to thank everyone today for joining us. And as always, if there's any additional questions, please feel free to reach out with further questions. Thank you very much.

Operator

Ladies and gentlemen, that concludes today's call. Thank you for your participating, and you may now disconnect.

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