T. Rowe Price Group Inc  TROW  ★★★  May 3, 2019

Quote Price vs. Fair Value | Financial Valuation | Operating Performance | Ownership Executive

Show Full Chart  Market Closed

$106.86 | 1.60 | 1.52

Previous Close

USD | NASDAQ | Last close prices updated as of May 03, 2019 4:15 PM EST | BATS BZX Real-Time Price

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<td>537,096.0 / 1.2 Mil</td>
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Consensus Forward P/E  Price/Book
14.31  4.00

Morningstar's Analysis  Summary  Competitors  Bulls Say/Bears Say

Assessment  Fair Value  5-Star Price
May 05, 2019  Apr 24, 2019  May 05, 2019
Fairly Valued  116.00  Under 81.20

1Q Market Rally Lifts T. Rowe Price's Near-Term Outlook; Increased FVE to $116 per Share

**Analyst Note**  |  by Greggory Warren  |  Updated Apr 24, 2019

We've increased our fair value estimate for wide-moat-rated T. Rowe Price to $116 per share from $106 following slightly better first-quarter results than we were forecasting. T. Rowe Price closed out the March quarter with $1.082 trillion in managed assets, up 12.4% sequentially and 6.7% year over year, driven primarily by stronger equity markets. Net inflows of $5.4 billion were a marked recovery from the $8.4 billion in outflows that the company saw during the fourth quarter, as investors started moving off the sidelines after a volatile December quarter. Target-date funds continue to account for the bulk of T. Rowe Price's organic growth, generating $3.0 billion in positive flows during the first quarter (on par with the $2.6 billion quarterly run rate during the past decade).

While average AUM was up 1.8% year over year during the March quarter, T. Rowe Price reported a 0.1% decrease in revenue compared with the prior year's period, due to a 4.1% decline in administrative, distribution, and servicing fees, as well as a lowering of its overall effective fee rate to 0.464% from 0.471% during the first quarter of 2018. Our revised forecast for 2019-23, which includes a market correction midcycle, has T. Rowe Price generating low- to mid-single-digit AUM growth on average, with organic growth averaging close to 2% annually and revenue expanding at a positive 1.1% CAGR compared with a negative 0.3% CAGR previously.
As for profitability, adjusted operating margins of 40.1% during the first quarter were 385 basis points lower than 2018 levels, as compensation and other expenses expanded at a faster rate than revenue. That said, this was slightly better than our forecast of 38% to 40% for the year, and as a result we've increased our projections, with this year looking to be a year with margins of around 40%-41% and our five-year forecast calling for margins of 39%-41% on average.

**Business Strategy and Outlook** | by Gregory Warren

*Updated Apr 24, 2019*

In an environment where active fund managers are under assault for poor relative performance and high fees, we believe wide-moat-rated T. Rowe Price is the best positioned among the U.S.-based active asset managers we cover. The biggest differentiators for the firm are the size and scale of its operations, the strength of its brands, its consistent record of active fund outperformance, and reasonable fees. T. Rowe Price has historically had a stickier set of clients than its peers, as well, with two thirds of its assets under management derived from retirement-based accounts. At the end of March 2019, 68%, 79%, and 82% of the company's funds were beating peers on a three-, five-, and 10-year basis, respectively, with 60% of funds rated 4 or 5 stars by Morningstar during the past five years, better than just about every other U.S.-based asset manager. T. Rowe Price also had a much stronger Morningstar Success Ratio—which evaluates whether a firm's open-end funds deliver sustainable, peer-beating returns over longer periods—giving it an additional leg up.

While T. Rowe Price will face headwinds in the near to medium term as baby boomer rollovers affect organic growth in the defined-contribution channel, we think the firm and defined-contribution plans in general have a compelling cost and service argument to make to pending retirees, which should mitigate some of the impact. We also believe T. Rowe Price is uniquely positioned among the firms we cover (as well as the broader universe of active asset managers) to pick up business in the retail-advised channel, given the solid long-term performance of its funds and reasonableness of its fees, exemplified by deals the past couple of years with Fidelity
Investments' FundsNetwork and Schwab's Mutual Fund OneSource platform. With T. Rowe Price likely to generate low- to mid-single-digit AUM growth on average going forward (driven by 1%-3% annual organic growth), we see top-line growth expanding at a positive 1.1% CAGR (due primarily to mix shift on ongoing industry fee pressures), with operating margins of 39%-41% on average.

**Economic Moat |** by Greggory Warren  
**Updated Apr 24, 2019**

In our view, the asset-management business is conducive to economic moats, with switching costs and intangible assets the most durable sources of competitive advantage for firms operating in the industry. Although the switching costs might not be explicitly large, inertia and the uncertainty of achieving better results by moving from one asset manager to another tend to keep many investors invested with the same funds for extended periods of time. As a result, money that flows into asset-management firms tends to stay there. For the industry as a whole, the average narrow redemption (retention) rate, which does not include exchange redemptions, has been 25% or less (75% or greater) annually during the past 5-, 10-, 15-, 20-, 25-, and 30-year time frames. Including exchange redemptions, the rate has been less than 30% (greater than 70%). Because T. Rowe Price does not break out its net flows (which are gross sales less investor redemptions) we assume that, based on its historical record of positive organic growth, the company's average annual redemption rate has been at its worst no worse than the industrywide rate, especially given the tailwinds that have been provided at times by defined contribution plans the past couple of decades--noting that redemptions have outpaced inflows into 401(k) plans since the baby boomer retirement phase started in 2011. During the past 5 (10) calendar years, T. Rowe Price's organic growth rate has averaged 0.7% (2.3%) with a standard deviation of 0.8% (3.3%), which meant that the firm was in most years compensating for investor redemptions with new flows into its products. As a reference point, the group of 12 U.S.-based asset managers we cover (including several above-average organic growth generators in BlackRock, Eaton Vance, and Cohen & Steers) had an average annual organic growth
rate of negative 0.3% (positive 0.9%) during 2014-18 (2009-18) with a standard deviation of 6.0% (7.5%). Meanwhile, the active asset managers as a whole (denoted by flows into U.S. open-end funds and ETFs tracked by Morningstar) generated a negative 1.9% (negative 0.7%) average annual organic growth rate the past 5 (10) calendar years with a standard deviation of 0.5% (1.3%). Going forward, we expect T. Rowe Price will generate a 1.4% average annual organic growth on average during 2018-22, with a standard deviation of 0.6%, compared with a group CAGR of negative 1.0%, with a standard deviation of 4.1%. Driven by recent large investments in retail distribution, enhanced product/vehicles and technology, T. Rowe Price should continue to have a better than average switching cost profile than its peers, despite continuing to see redemption rates that we believe are at/above the industry average (due to the continuation of the baby boomer retirement cycle).

We believe that traditional asset managers like T. Rowe Price can improve on the switching cost advantage inherent in their business models with organizational attributes (such as product mix, distribution channel concentration, and geographic reach) and intangible assets (such as strong and respected brands and manager reputations derived from successful, sustainable track records of investment performance). This can provide them with a degree of differentiation from their peers. While the barriers to entry are not all that significant for the industry, the barriers to success are extremely high, as it not only takes time and skill to put together a long enough record of investment performance to start gathering assets but even more time to build the scale necessary to remain competitive in the industry. This has generally provided the larger, more established asset managers with an advantage over the smaller players in the industry, especially when it comes to gaining cost-effective access to distribution platforms. Competition for investor inflows can be stiff and has traditionally centered on investment performance, especially in the retail channel. Although institutional investors and retail gatekeepers are exerting pressure on pricing, competition based on price has been rare, aside from what we've seen in the U.S. market for exchange-traded funds. While compensation remains the single-
largest expense for most asset managers, supplier power has been manageable as many firms have reduced their reliance on star managers and have tied manager and analyst pay to both portfolio and overall firm performance. Asset stickiness (the degree to which assets remain with a manager over time) tends to be a differentiator between wide- and narrow-moat firms, as those asset managers that have demonstrated an ability to gather and retain investor assets during different market cycles have tended to produce more stable levels of profitability, with returns exceeding their cost of capital for longer periods. While the more broadly diversified asset managers are structurally set up to hold on to assets regardless of market conditions, it has been firms with solid product sets across asset classes (built on repeatable investment processes), charging reasonable fees, and with singular corporate cultures dedicated to a common purpose that have done a better job of gathering and retaining assets. Firms offering niche products with significantly higher switching costs--such as retirement accounts, funds with lockup periods, and tax-managed strategies--have tended to hold on to assets longer.

T. Rowe Price, in our view, has a wide economic moat around its operations. We think the company's size and scale, the strength of its brands, and its consistent record of active fund outperformance provides the firm with a huge leg up over competitors. While T. Rowe Price's product mix is not overly diverse, with closer to 90% of its $1.082 trillion in AUM at the end of March 2019 dedicated to equity (57%) and balanced (30%) strategies, the company derives a significant portion (approximately two thirds) of its managed assets from retirement accounts (41%) and variable-annuity portfolios (26%). With the switching costs for these types of tax-deferred accounts being significantly higher than those for most other accounts (the majority of which are non-tax-deferred), T. Rowe Price has traditionally had a much stickier set of assets than its peers.

Benefiting from a steady stream in investor inflows into defined contribution and other retirement plans, the firm has recorded net long-term outflows in only 14 calendar quarters during the past two decades. Furthermore, the firm's cost-conscious culture and stable
AUM and revenue levels have allowed it to consistently generate operating margins in excess of 40% (the highest among the U.S.-based asset managers we cover). T. Rowe Price's ability to generate more stable revenue, profitability, and cash flows than its peers has, in our view, provided the company with more than enough excess capital to continue building on the competitive advantages that it already possesses. The firm has been fairly effective managing its scale, with adjusted operating margins of 44.3% on average during 2014-18, allowing it to generate around $1.5 billion in annual free cash flow on average, with adjusted ROICs exceeding 55% (and ROICs with goodwill exceeding 44%).

T. Rowe Price's biggest advantage over peers has been the level and consistency of its investment performance. The firm currently has 37% of its fund AUM rated 5 stars, and another 25% rated 4 stars, on a five-year basis. With most broker/dealer and advisory platforms tending to give deferential treatment to 4- and 5-star funds, T. Rowe Price is well-positioned. With solid three- and five-year relative investment performance generated on a consistent basis also tending to be an important benchmark for the gatekeepers of retail-advised and institutional platforms, T. Rowe Price is also well-positioned, with more than three quarters of its funds tending to outperform peers on a three-, five-, and ten-year basis for much of the past two decades. With 75%, 79%, and 83% of T. Rowe Price's sponsored U.S. mutual funds beating their peers on a three-, five-, and ten-year basis, respectively, at the end of 2018, we expect the firm to continue to generate better organic growth from its active fund platform than the industry as a whole. Another measure that demonstrates the strength of T. Rowe Price's investment acumen is Morningstar's Success Ratio, which measures the potential for a firm's funds to generate sustainable, peer-beating returns over the long run. Morningstar calculates two different success ratios--the Morningstar Success Ratio and the Morningstar Risk-Adjusted Success Ratio--over three-, five-, and ten-year time frames, with the former considering each fund's category rank based on total return and the latter looking at a fund's category rank based on Morningstar Risk-Adjusted Return. The higher the Success Ratio, the greater chance that investors will see
sustainable, peer-beating returns. By this measure, T. Rowe Price is
the only winner among the 12 asset managers we cover, with a five-
year Risk Adjusted Success Ratio of 75.0 compared with a group
average (median) of 48.3 (48.6). Compared with the broader universe
of fund families, T. Rowe also scores well, with its five-year Risk
Adjusted Success Ratio beating the industry average (median) of 46.5
(44.0).

Much of the success T. Rowe Price has had historically has been built
on the firm having a single corporate culture dedicated to a common
purpose, which has been reflected in the level and consistency of its
investment performance, the rate of organic growth the company has
been able to generate, and the relatively small amount of employee
turnover through the years. Morningstar views the management team
at T. Rowe Price as being highly insular and very protective of the
culture that the firm has built—one that has cultivated a disciplined,
risk-conscious investment process that has consistently produced
successful results across its fund lineup, often with less volatility than
peers. As part of ongoing efforts to enhance the company's
competitive positioning, management has been willing to evolve,
though, focusing for much of the past several years on building
additional scale through new investment products, expanding the
reach of its investment advisory business by further penetrating
domestic distribution channels (like the retail-advised channel) and
moving into non-U.S. markets (especially emerging and developing
economies in the Asia-Pacific region), and bolstering technology in an
effort to improve performance outcomes, drive down incremental
costs, and improve product distribution. Chairman and CEO Bill
Stromberg maintains an investment focus while recognizing that the
business must evolve to flourish in an industry that's gravitated
toward passive investing. All of which explains why T. Rowe Price
receives some of the highest marks for corporate culture among the
U.S.-based asset managers we cover. Our manager research group
has also consistently awarded them a Positive Parent rating, owing
not only to their ability to produce repeatable investment strategies
but to prudently adapt to the changing competitive landscape all
while attracting and retaining quality investment talent. We continue
to believe that T. Rowe Price is well-positioned to navigate the headwinds that the U.S.-based asset managers will face during the next decade and expect it to be one of the rare organic growth generators in the group.

**Fair Value and Profit Drivers** | by Greggorry Warren  Updated Apr 24, 2019

We've increased our fair value estimate for T. Rowe Price to $116 per share from $106 after updating our near- to medium-term assumptions about AUM, revenue, and profitability. Our new fair value estimate implies a price/earnings multiple of 16.0 times our 2019 earnings estimate and 15.7 times our 2020 earnings estimate. For some perspective, during the past five (ten) calendar years, T. Rowe Price's shares have traded at an average of 16.3 (20.1) times trailing earnings. We use a 9% cost of equity in our valuation.

The company closed out the March quarter with $1.082 trillion in AUM, up 6.7% year over year. Net inflows of $5.4 billion were a marked recovery from the $8.4 billion in outflows the firm posted during the fourth quarter, as investors moved off the sidelines after a volatile December quarter. Target-date funds continue to generate the bulk of T. Rowe Price's organic growth, generating $3.0 billion in positive flows during the first quarter (on par with the $2.6 billion quarterly run rate we've seen during the past decade).

Despite reporting a 0.1% decline in revenue during the first quarter, due to a 4.1% decline in administrative, distribution and servicing fees, as well as a lowering of its overall effective fee rate to 0.464% from 0.471% year over year, we expect the firm to generate low-single-digit top-line growth during 2019, driven by the equity market recovery in the first quarter, as well as easier comps in the back half of the year. Our forecast for 2019-23, which includes another market correction, has T. Rowe Price generating low- to mid-single-digit AUM growth on average, with organic growth averaging close to 2% annually and revenue expanding at a positive 1.1% CAGR (compared with a negative 0.3% CAGR previously).

Adjusted operating margins of 40.1% during the first quarter were 385 basis points lower than 2018 levels, as compensation and other expenses expanded at a faster rate than revenue. This was, however,
slightly better than our forecasted range of 38% to 40% for the year. As a result, we've increased our profitability projections for the firm, with this year looking to be a year with margins of around 40%-41% and our five-year forecast calling for margins of 39%-41% on average.

While down from the 44%-45% operating margins T. Rowe Price posted during 2014-18, it is endemic of the headwinds facing the industry, as participants need to spend more heavily on technology, new products and distribution to remain competitive.

**Risk and Uncertainty** | by Greggory Warren  Updated Apr 24, 2019

With more than 80% of annual revenue derived from management fees levied on AUM, dramatic market movements, shifts in product mix, and/or changes in fund flows can have a significant impact on operating income and cash flows. T. Rowe Price's investment offerings are overwhelmingly tied to U.S. equity markets, with more than three fourths of its AUM invested in equity and balanced strategies. Additionally, 10 T. Rowe Price funds--Blue-Chip Growth, Growth Stock, Capital Appreciation, Mid-Cap Growth, New Income, New Horizons, Value, Equity Income, Overseas Stock and International Stock--accounted for 29% of the firm's AUM at the end of 2018, as well as more than a third of the company's investment advisory revenue during the year. As T. Rowe Price increases its investment in overseas asset managers, especially in emerging and developing economies like China and India, it is exposing itself to myriad cultural, economic, political, and currency risks that exist in the markets these managers serve.

**Stewardship** | by Greggory Warren  Updated Apr 24, 2019

T. Rowe Price is unique among the U.S.-based asset managers we cover in that it has traditionally been run by a group of top officers (the management committee) who consult one another before making major decisions. President and CEO William Stromberg started working for T. Rowe Price in 1987 and previously served as head of equity (2008-15), director of U.S. equity (2007-15), and director of global equity research (2004-15) before taking the top job in January 2016. Following the retirement of Brian Rogers as chairman of the
board of directors at the end of April 2019, Stromberg will assume that role as well. Key members of the company's current management committee include: Celine Dufetel, chief financial officer; Christopher Alderson, co-head of global equity; Rob Sharps, head of investments and group chief investment officer; Eric Veiel, co-head of global equity; Andrew McCormick, head of fixed income; Scott David, head of individual and retirement plan services; Robert Higginbotham, head of global investment management services; Sebastien Page, head of global multi-asset allocation; and Nigel Faulkner, head of global technology.

The management committee, which is responsible for guiding, implementing, and reviewing major policy and operating initiatives, has in our view done an exemplary job over the years. Capital allocation has been prudent, with the company carrying little to no debt on its books, engaging in very little acquisition activity, and tending to return cash to shareholders as share repurchases and dividends. In the asset-management industry, debt can be a net negative, as was seen during the 2008-09 global financial crisis when several firms that were carrying larger levels of debt had to scramble to raise capital (including issuing additional equity) after seeing revenue and profitability drop dramatically in response to the market decline. Compensation has tended to be reasonable at T. Rowe Price, with executive pay being in line with most of the larger asset managers we cover. The only issue we have with the firm is that it has been a heavy user of stock options over the years, which not only dilutes existing shareholders but also blunts the impact of its share-repurchase programs.

As part of ongoing efforts to enhance the company's competitive positioning, management has been focused on building additional scale through new investment products, like its target-date retirement funds, expanding the reach of its investment advisory business by further penetrating domestic distribution channels and moving into non-U.S. markets (especially in emerging and developing economies), and investing in technology and business transformation aimed at improving client experiences and delivering operating efficiencies.
across the enterprise. Some of these efforts have paid off handsomely, as T. Rowe Price has seen investor outflows from its long-term AUM in just 14 calendar quarters the past two decades. More important, the firm has generated average quarterly inflows of $2.6 billion since the start of 2009 and has been one of only a handful of large-cap equity managers to generate active inflows since the financial crisis, driven by the strong relative performance of its funds and effectiveness of its sales efforts.

Target-date retirement portfolios remain the largest driver of growth for T. Rowe Price. During the past five years, the firm has pulled in more than $58 billion in managed assets with its target-date retirement portfolios, which currently account for 24% of firmwide AUM. The company has also made some headway in the retail-advice channel by highlighting its record of active fund performance to advisors, many of whom are more focused on low-cost index funds and exchange-traded funds as they've moved to fee-based account models to serve their clients. T. Rowe Price also remains focused on expanding its international business (currently around 6% of total AUM), making strategic investments in products and personnel as it looks to build up its brand as well as broaden its reach overseas. And with its technology investments, the firm aims to be able to improve investment performance and better target end users, as well as build tools that allow advisors to build better portfolios.

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Company Profile

Business Description
T. Rowe Price provides asset-management services for individual and institutional investors. It offers a broad range of no-load U.S. and international stock, hybrid, bond, and money market funds. At the end of March 2019, the firm had $1.082 trillion in managed assets, composed of equity (57%), balanced (30%) and fixed-income (13%) offerings.
Approximately two thirds of the company's managed assets are held in retirement accounts and variable-annuity investment portfolios, which provides T. Rowe Price with a somewhat stickier client base than most of its peers. The firm also manages private accounts, provides retirement planning advice, and offers discount brokerage and trust services. The company is primarily a U.S.-based asset manager, deriving just 6% of its AUM from overseas.

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