T. Rowe Price Group TROW

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Investment portfolio reallocations are not enough to upend T. Rowe Price's wide economic moat.

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Analyst Note

Institutional and Intermediary Outflows Mar T. Rowe Price's 3Q Results; No Change to $75 Fair Value
by Greggory Warren, CFA, 10/24/2013

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Investment Thesis 11/19/2013

T. Rowe Price has produced impressive AUM and revenue growth over the last two decades thanks to its strong brand, solid fund performance, and mostly favorable market conditions. Although that track record of strong organic growth has been challenged of late as strategic reallocations by certain institutional and intermediary clients have left the firm in net redemption mode, we don't think it will have a lasting impact on the firm's ability to generate flows. With close to 60% of its AUM held in retirement accounts and variable-annuity investment portfolios, the firm has a far stickier set of assets than its peers, and benefits from a nearly constant flow of capital into these types of funds. Most active equity funds are rolling off five-year performance figures that the 2008-09 financial crisis negatively affected, and investors are warming up to equities (and taking a more conservative stance on fixed income). We expect moderate levels of organic growth and improved realization rates to drive double-digit revenue growth in 2014, as product mix shifts more toward equities.

We believe the bulk of T. Rowe Price's growth will come from its target-date retirement fund platform, which over the last five years has grown from $31.1 billion in total AUM to $109.5 billion. Organic growth for these funds, which offer investors a way to invest for retirement that is based on their expected retirement date (and which automatically adjusts the asset mix as time passes), has averaged

Morningstar's Take TROW

Analyst

Price 11-19-2013	**Fair Value Estimate**	**Uncertainty**
80.05 USD	81 USD	Medium
Consider Buy	**Consider Sell**	**Economic Moat**
56.7 USD	109.35 USD	Wide
Stewardship Rating		
Exemplary		

Bulls Say

- With $647.2 billion in total AUM at the end of third quarter 2013, T. Rowe Price is one of the larger U.S.-based asset managers. Retirement accounts and variable-annuity investment portfolios account for about 60% of the firm's managed assets.
- At the end of the third quarter of 2013, 74%, 78%, and 82% of T. Rowe Price's mutual funds were beating their peers on a 3-, 5-, and 10-year basis, respectively.
- Target-date retirement portfolios have been a significant source of organic growth for T. Rowe Price, accounting for more than half of inflows during the last five years.

Bears Say

- T. Rowe Price is not as diverse as it could be, with three fourths of its total AUM tied up in equity and balanced strategies and just 7% of its managed assets sourced from international clients.
- Near-term performance of T. Rowe Price's mutual funds has fallen off, with just 66% of funds beating their peers on a one-year basis at the end of third quarter 2013.

around 3% on a quarterly basis the last few years, and is expected to average around 2% quarterly as we move forward. This is on par with some of the best organic growth stories in our universe, with only the growth of exchange-traded funds being stronger right now. We expect the growth of these products to continue to contribute to solid increases in revenue and profitability for T. Rowe Price, with the firm's free cash flow expanding from just over $800 million last year to more than $1.4 billion by the end of our five-year forecast.

Economic Moat 11/19/2013

The publicly traded asset managers tend to have economic moats, with switching costs and intangible assets being the most durable sources of competitive advantage for firms in the asset-management industry. Although the switching costs might not be explicitly large, the benefits of switching from one asset manager to another are at times so uncertain that many investors take the path of least resistance and stay where they are. As a result, money that flows into asset-management firms tends to stay there--borne out by an average annual redemption rate for long-term mutual funds of around 30% during the last five-, 10-, 15-, 20-, and 25-year time frames. We believe asset managers can improve on the switching cost advantage inherent in the business with structural attributes (such as product mix, distribution channel concentration, and geographic reach) and intangible assets (such as strong brands and entrenched sales relationships), which provide them with a level of differentiation.

Although the barriers to entry are not significant for the industry, it takes time and skill to gather the level of assets necessary to build scale. This provides large, established asset managers with an advantage over smaller players, especially when it comes to gaining cost-effective access to distribution platforms. Asset stickiness--which is the degree to which assets remain with a manager over time--tends to be a bigger distinguisher between wide- and narrow-moat firms, in our view. Companies that have shown 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 of time. While more broadly diversified asset managers are structurally set up to hold on to assets regardless of market conditions, it has been firms with both solid product sets across asset classes and singular corporate cultures dedicated to a common

- With a large portion of the firm's assets generating fees based on daily AUM rather than monthly or quarterly averages, T. Rowe Price's revenue will be affected more heavily during periods of extreme market volatility.

Competitors TROW More...

Name	Price	% Chg	TTM Sales $ mil
T. Rowe Price Group	**$80.05**	**0.06**	**3,342**
Bank of New York Mellon Corp	$33.08	-0.15	15,006
BlackRock Inc	$303.70	-0.08	9,942
State Street Corp	$71.07	0.11	9,869
Franklin Resources Inc.	$53.89	0.15	7,985
CaixaBank SA	$5.20	-0.57	5,651

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purpose that have tended to thrive. Asset managers offering niche products with significantly higher switching costs--such as retirement accounts, funds with lock-up periods, and tax-managed strategies--have also been able to hold on to assets longer.

T. Rowe Price, in our view, has a wide economic moat around its operations. The company remains one of the better-positioned asset managers in our coverage universe, with high customer switching costs, a well-respected brand, and ample size and scale being the cornerstones of its wide economic moat. While its product mix is not overly diverse, with close to three fourths of total AUM dedicated to equity and balanced strategies, the company derives a significant portion (approximately 60%) of its managed assets from retirement accounts and variable-annuity portfolios. With the switching costs for these types of accounts being significantly higher than those for most other accounts, T. Rowe Price has a much stickier set of assets than many of its peers. The firm also benefits from a steady stream in investor inflows, having recorded net outflows in only five calendar quarters--the fourth quarter of 2008, the third quarter of 2011, the fourth quarter of 2012, the second quarter of 2013, and the third quarter of 2013--during the last decade.

This has allowed T. Rowe Price to generate more stable revenue, profitability, and cash flows than its peers and provides the company with more than enough capital to continue building on the competitive advantages that it already possesses. The firm's higher fee rates (given its heavier concentration in equity and blended strategies) have allowed it to generate operating margins in excess of 40% the last few years (the highest among the asset managers we cover), with free cash flow exceeding $800 million last year (and on pace to crack $1 billion in 2013). Given the strength of its product portfolio, which includes solid-performing funds across both its equity and fixed-income platforms, its ability to generate some of the strongest organic growth in our coverage universe, and the firm's knack for holding on to assets better than its peers, we think T. Rowe Price has a fairly wide moat around its operations.

Valuation 11/19/2013

We've increased our fair value estimate for T. Rowe Price to $81 per share from $75 to reflect changes in our assumptions about the firm's AUM, revenue, and profitability since our last update. This new fair value estimate implies a P/E multiple of 20.9 times our 2013 earnings estimate, 18.7 times our 2014 earnings estimate, and 17.3 times our 2015 earnings estimate. T. Rowe Price has generally garnered a higher multiple than the rest of the asset managers, primarily because its business model tends to generate more-consistent inflows and much stickier assets than its peers.

With the U.S. equity markets up more than 5% since the end of September, and credit markets on much better footing than they were during the second and third quarter, we expect T. Rowe Price to close out 2013 with more than $675 billion in total AUM, reflective of an 18% increase year over year. With average AUM expected to be up 15% during 2013, and the firm seeing a minor improvement in its realization rate (as a result of ongoing mix shift), we expect revenue to increase at the upper end of our 10%-15% forecast for the full year.

We see the potential for revenue to grow at a double-digit rate in 2014 as well, as increased interest in equities (especially with five-year performance numbers improving as results from the 2008-09 financial crisis roll off), and decreased interest in fixed income, lead to a moderate level of organic growth and improved realization rates (as product mix shifts more towards equities). After 2014, we expect more moderate levels of AUM growth to translate into 6%-7% annual top-line growth during the final years of our five-year projection period. The net result is a 9% CAGR for revenue from 2012 to 2017 (basically in line with the firm's rate of annual revenue growth over the last five years).

With operating margins through the first nine months of 2013 sitting at 47%, T. Rowe Price's profitability is running 100 basis points higher than our projection for the full year. We expect the firm to close out 2013 with operating margins at around 47%, with profitability expanding as a percentage of sales as the size and scale of the firm's operations increases. That said, we do expect the firm to have to commit more money to sales and distribution than it might have in past periods, limiting the expansion of its operating margins, which we expect to be around 48% at the end of our forecast period. We use a 10% cost of equity in our valuation.

Risk 11/19/2013

With more than 80% of annual revenue derived from management fees levied on AUM, dramatic market movements 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 three fourths of its AUM invested in equity and balanced strategies. Additionally, six T. Rowe Price funds--Growth Stock (PRGFX), Equity Income (PRFDX), Mid-Cap Growth (RPMGX), Blue-Chip Growth (TRBCX), Value (TRVLX), and New Income (PRCIX)--accounted for 21% of the firm's AUM at the end of last year and 25% of its investment advisory revenue during 2012. As T. Rowe Price increases its investment in overseas asset managers, especially in emerging and developing economies like China and India, the firm is exposing itself to myriad cultural, economic, political, and currency risks that exist in the markets these managers serve.

Management 11/19/2013

T. Rowe Price is unique among the 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. Current president and CEO James Kennedy started working for T. Rowe Price in 1978 and served as director of equity research (1987-99) and director of the equity division (1997-2006) before taking the role of chief executive. Chairman Brian Rogers ascended to his role at the same time that Kennedy became president and CEO, and continues to serve as chief investment officer, a role he has held since 2004. Other members of the management committee are Edward Bernard, vice chairman of the board of directors; William Stromberg, global head of equities and equity research; Michael Gitlin, global head of the fixed-income division; Christopher Alderson, head of international equities; and John Linehan, head of U.S. equities.

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 in the form of share repurchases and dividends. In the asset-management industry, debt can be a net negative, as was seen during the 2008-09 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, with executive pay being in line with most of the larger asset managers we cover. The one issue we do have is that T. Rowe Price has been a heavy user of stock options, which not only dilute existing shareholders but also blunt the impact of its share-repurchase programs.

As part of its ongoing effort to enhance the firm's competitive positioning, the management committee has been focused on building additional scale through new investment products, like its target-date retirement funds, and 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, where T. Rowe Price aims to garner first-mover advantage over some of its larger peers). Many of these efforts have paid off handsomely, as T. Rowe Price has seen investor outflows in just five calendar quarters during the last 10 years. More important, the firm has generated average quarterly inflows of $3.9 billion since the start of 2009, being one of only a handful of asset managers that have been able to generate equity inflows since the financial crisis, driven primarily by the stronger relative performance of its funds and the effectiveness of its sales efforts.

Target-date retirement portfolios remain the largest driver of growth for T. Rowe Price. During the last five years, the firm has pulled in more than $40 billion in managed assets with its target-date retirement portfolios, which at $109.5 billion in total AUM at the end of the third quarter of 2013 accounted for 17% of T. Rowe Price's total AUM and 27% of its mutual fund assets. The company has also made headway in the advisor channel, picking up business with more and more advisors that are using fee-based models to service their clients. And while it has been affected by outflows from institutional investors and third-party financial intermediaries of late, these accounts represent a relatively small portion of T. Rowe Price's total managed assets, and we don't view their actions as being indicative of a broader trend in the company's portfolio. That said, it does represent a mild setback for the firm, which had viewed these two distributional channels, which can be as sticky as the retirement channel it already serves, as meaningful areas of growth longer run.

Overview

Profile:

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, blended asset, bond, and money market funds. Around 60% of the firm's assets under management are held in retirement accounts and variable-annuity investment portfolios. T. Rowe Price also manages private accounts, provides retirement planning advice, and offers discount brokerage and trust services. The company had $647.2 billion in total AUM at the end of the third quarter of 2013.
