Legg Mason (LM)

Updated December 11th, 2018 by Eli Inkrot

Key Metrics

Current Price:	$27	**5 Year CAGR Estimate:**	14.6%	**Volatility Percentile:**	80.0%
Fair Value Price:	$34	**5 Year Growth Estimate:**	5.0%	**Momentum Percentile:**	6.5%
% Fair Value:	80%	**5 Year Valuation Multiple Estimate:**	4.6%	**Growth Percentile:**	31.0%
Dividend Yield:	5.0%	**5 Year Price Target**	$43	**Valuation Percentile:**	82.4%
Dividend Risk Score:	D	**Retirement Suitability Score:**	C	**Total Return Percentile:**	83.3%

Overview & Current Events

Founded in 1899, Maryland-based asset manager Legg Mason (LM), employs about 3,300 people and had assets under management of $755 billion as of September 30th, 2018. Products by asset class include fixed income (55%), equities (28%), alternative investments (9%) and liquidity (8%). Geographically, 70% of Legg Mason's clients are domiciled in the U.S. The company, with a market capitalization of $2.3 billion, is on pace to generate about $3 billion in revenue (0.4% of assets) and earn around $275 million this year.

On October 24th, 2018 Legg Mason reported second quarter fiscal year 2019 results. Highlights included $72.8 million in net income ($0.82 per diluted share), $755.4 billion in assets under management and long-term net outflows of $1.0 billion. On the balance sheet, the cash position stood at $611 million against total debt of $2.2 billion.

On November 12th, 2018 Legg Mason reported preliminary assets under management of $733.0 billion, driven by $0.6 billion in net inflows, a $0.4 negative impact from foreign exchange and a sizable decrease in market values.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	-$13.85	$1.32	$1.63	$1.54	$2.61	$2.33	$2.63	-$0.25	$2.18	$3.72	***$3.20***	***$4.08***
DPS	$0.96	$0.12	$0.20	$0.32	$0.44	$0.52	$0.64	$0.80	$0.88	$1.12	***$1.36***	***$1.74***
Shares	142	164	150	140	125	117	111	107	96	85	***86***	***80***

Note that Legg Mason's fiscal year ends at the end of March of the following year.

Legg Mason's recession record is volatile. Back in 2006 the company was earning $4.50 per share and paying out a healthy dividend. When the financial recession came, the company lost $13.85 per share and slashed its dividend from $0.96 down to $0.12. In turn, the share price fell dramatically from $130 in 2006 all the way down to a low of $10 in 2009. Since that time the company has got back on its feet, incrementally improving with the dividend finally hitting its pre-recession mark but earnings-per-share still lagging.

In the 2010 to 2016 stretch, Legg Mason grew earnings-per-share by about 5% annually. This is the number we have used in our growth estimate. Legg Mason is not immune from the problem that plagues nearly all asset managers; specifically, the move away from high-fee options and toward low-cost, passive investment vehicles. This shows up in revenues collected, as asset managers must either reduce the fees they charge or risk losing customers. The good news is that the bulk of Legg Mason's assets under management are already in low cost options including Fixed Income and Liquidity, with operating revenue yields of 27 and 14 basis points respectively (0.27% and 0.14%). The bad news is that this trend does not appear to be going away and will weigh heavily on asset managers' ability to grow. Moreover, should interest rates rise substantially this could weigh on the company's fixed income business.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/B	0.49	0.79	0.94	0.69	0.84	1.22	1.37	0.88	0.87	0.90	***0.56***	***0.70***
Avg. Yld.	2.9%	0.5%	0.6%	1.1%	1.7%	1.4%	1.2%	1.8%	2.7%	2.9%	***5.0%***	***4.3%***

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We are using the P/B ratio to analyze Legg Mason's valuation due to the company's volatile earnings history. Legg Mason's average price-to-book ratio over the past decade is 0.90. As of the most quarter Legg Mason had $7.9 billion in total assets, but $5.66 billion (72%) of this was in the form of intangible assets and goodwill.

Legg Mason looks attractive from a valuations standpoint as it is trading at a P/E of ~8, a P/B of 0.56, and has a 5% dividend yield. However, it also reflects a lot of uncertainty with asset managers in general and with the business performance should we see a substantial downturn in the years to come. We expect valuation multiple expansion to a P/B of 0.70 over the next 5 years, resulting in an annualized boost of 4.6 percentage points.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
Payout	NA	24%	11%	20%	16%	22%	23%	NA	39%	29%	***43%***	***43%***

Asset managers enjoy small moats in the way of switching costs. Once you are set up with an asset manager it is a hassle to change and the benefits of switching are unknown. However, pricing power does not exist and indeed could be a key detrimental driver in the years ahead.

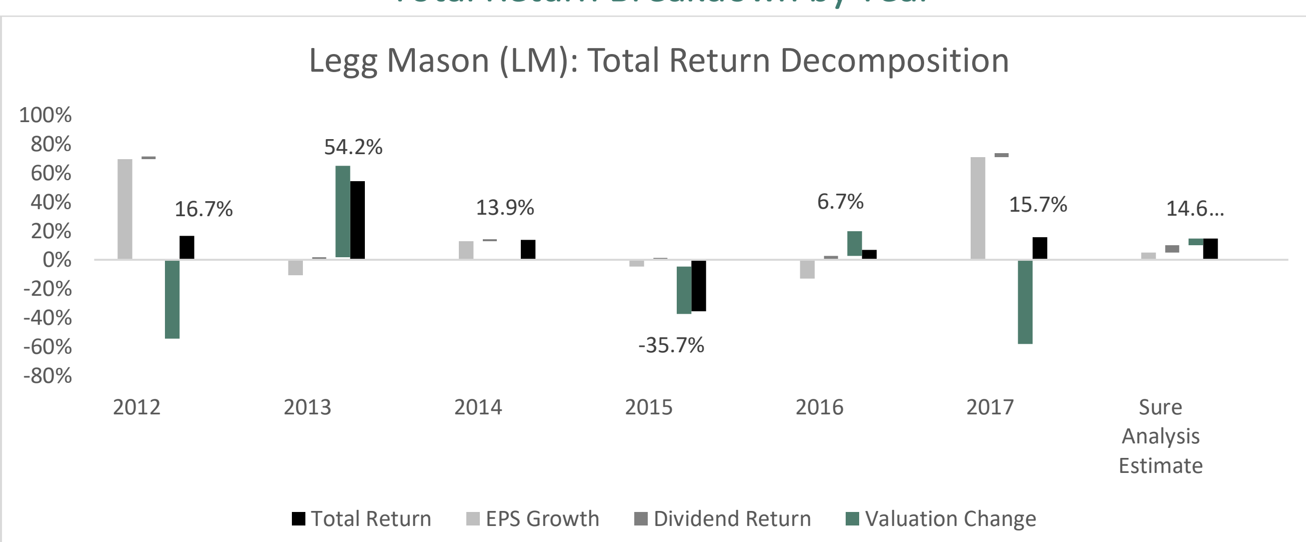
During the last recession Legg Mason did not perform well, showing a dividend cut and diluting the share count to boot. Legg Mason is likely to perform poorly during the next recession.

The payout ratio is reasonable, coming in at 43% of expected profits. In the last few years this mark has been much lower, allowing for a significant number of shares to be retired in the interim. Current assets cover current liabilities 2-to-1. However, we caution that interest payments totaled $118 million last year against underlying profits closer to $300 million – in lesser times interest payments could force dilutive actions.

Final Thoughts & Recommendation

Legg Mason offers high expected total returns due to its high yield and low valuation. But, the company has an elevated amount of risk. In particular, the industry faces long-term headwinds in the way of asset managers having to charge lower and lower fees to compete. Also, Legg Mason is likely to suffer in a market downturn. Legg Mason offers high returns but has *high risk* as well. Only the most aggressive investors should consider this stock.

Total Return Breakdown by Year



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Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	3357	2635	2784	2663	2613	2742	2819	2661	2887	3140
Gross Profit	N/A	N/A	886	869	824	912	992	910	986	1142
Gross Margin	N/A	N/A	31.8%	32.6%	31.5%	33.3%	35.2%	34.2%	34.2%	36.4%
SG&A Exp.	2500	2123	300	320	322	273	292	320	323	314
D&A Exp.	138	114	103	94	88	63	55	60	80	73
Operating Profit	639	321	387	339	300	431	498	388	418	522
Operating Margin	19.0%	12.2%	13.9%	12.7%	11.5%	15.7%	17.7%	14.6%	14.5%	16.6%
Net Profit	-1968	204	254	221	-353	285	237	-25	227	285
Net Margin	-59%	7.8%	9.1%	8.3%	-13.5%	10.4%	8.4%	-0.9%	7.9%	9.1%
Free Cash Flow	279	1329	379	465	265	397	522	414	500	456
Income Tax	-1223	119	119	72	-151	138	125	8	84	-103

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	9232	8623	8708	8556	7270	7111	7065	7520	8290	8153
Cash & Equivalents	1084	1466	1376	1408	980	914	672	1329	734	739
Accounts Receivable	600	349	367	334	351	349	368	335	433	476
Goodwill & Int. Ass.	5110	5218	5188	5132	4447	4412	4653	4626	5959	5730
Total Liabilities	4634	2751	2901	2878	2451	2387	2580	3285	4279	4300
Long-Term Debt	2990	1420	1730	1659	1353	1039	1049	1781	2222	2347
Shareholder's Equity	4599	5842	5770	5677	4818	4725	4485	4214	3983	3824
D/E Ratio	0.65	0.24	0.30	0.29	0.28	0.22	0.23	0.42	0.56	0.61

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	-18.7%	2.3%	2.9%	2.6%	-4.5%	4.0%	3.3%	-0.3%	2.9%	3.5%
Return on Equity	-35.1%	3.9%	4.4%	3.9%	-6.7%	6.0%	5.1%	-0.6%	5.5%	7.3%
ROIC	-23.2%	2.7%	3.4%	3.0%	-5.2%	4.8%	4.2%	-0.4%	3.7%	4.6%
Shares Out.	142	164	150	140	125	117	111	107	96	85
Revenue/Share	23.87	16.96	17.91	18.57	19.61	22.40	24.89	24.77	28.64	34.44
FCF/Share	1.98	8.55	2.44	3.24	1.99	3.24	4.61	3.86	4.96	5.00

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.