



Legg Mason Inc. (LM)

Updated February 5th, 2019 by Eli Inkrot

Key Metrics

Current Price:	\$30	5 Year CAGR Estimate:	10.1%	Volatility Percentile:	72.2%
Fair Value Price:	\$31	5 Year Growth Estimate:	5.0%	Momentum Percentile:	11.5%
% Fair Value:	97%	5 Year Valuation Multiple Estimate:	0.6%	Growth Percentile:	33.3%
Dividend Yield:	4.5%	5 Year Price Target	\$40	Valuation Percentile:	55.2%
Dividend Risk Score:	D	Retirement Suitability Score:	C	Total Return Percentile:	57.3%

Overview & Current Events

Founded in 1899, Maryland-based asset manager Legg Mason (LM), employs about 3,300 people and had assets under management (AUM) of \$727 billion as of December 31st, 2018 (down from \$755 billion on September 30th, 2018). Products by asset class include Fixed Income (56% of AUM), Equities (25%), Liquidity (10%) and Alternative Investments (9%). Geographically, 68% of Legg Mason's clients are domiciled in the U.S. The \$2.5 billion market cap company generates about \$3 billion in annual revenue (0.4% of assets).

On February 4th, 2019 Legg Mason reported Q3 fiscal year 2019 results for the period ending December 31st, 2018 (Note the company's fiscal quarter ends March 31st). The company reported \$727.2 billion in assets under management, driven by \$30.0 billion in negative market performance and \$8.5 billion in net outflows. Operating revenues came in at \$704 million, down from \$793 million in Q3 2018, as a result of both lower performance fees and AUM. Legg Mason reported a \$217 million net loss, or -\$2.55 per share, as a result of impairment charges with the EnTrustPermal and RARE Infrastructure contracts and tax items. Excluding these items, earnings-per-share would have totaled \$0.73 against \$0.82 in the previous quarter.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	-\$13.85	\$1.32	\$1.63	\$1.54	\$2.61	\$2.33	\$2.63	-\$0.25	\$2.18	\$3.72	\$3.10	\$3.96
DPS	\$0.96	\$0.12	\$0.20	\$0.32	\$0.44	\$0.52	\$0.64	\$0.80	\$0.88	\$1.12	\$1.30	\$1.66
Shares	142	164	150	140	125	117	111	107	96	85	86	80

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, as we believe it incorporates a "normal," if not positive, environment without the impact of the recession or the substantial, but unlikely to repeated recent performance.

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 13 basis points respectively (0.27% and 0.13%). 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 negatively influence the company's fixed income business.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	N/A	20.1	19.6	18.7	10.0	16.0	19.6	N/A	15.0	10.5	9.7	10.0
Avg. Yld.	2.9%	0.5%	0.6%	1.1%	1.7%	1.4%	1.2%	1.8%	2.7%	2.9%	4.3%	4.2%

Legg Mason's valuation history has been quite volatile over the past decade – posting two years of losses and trading between 9 and 20 times earnings. We believe a multiple near 10 times earnings is reasonable, more or less in-line with

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what we expect from the company's peers. This reflects a lot of the uncertainty with asset managers in general and with the business performance should we see a substantial downturn in the years to come.

Meanwhile, the dividend should add nicely from this point, while share repurchases can aid in growth given the lower valuation of the security.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	N/A	24%	11%	20%	16%	22%	23%	N/A	39%	29%	42%	42%

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.

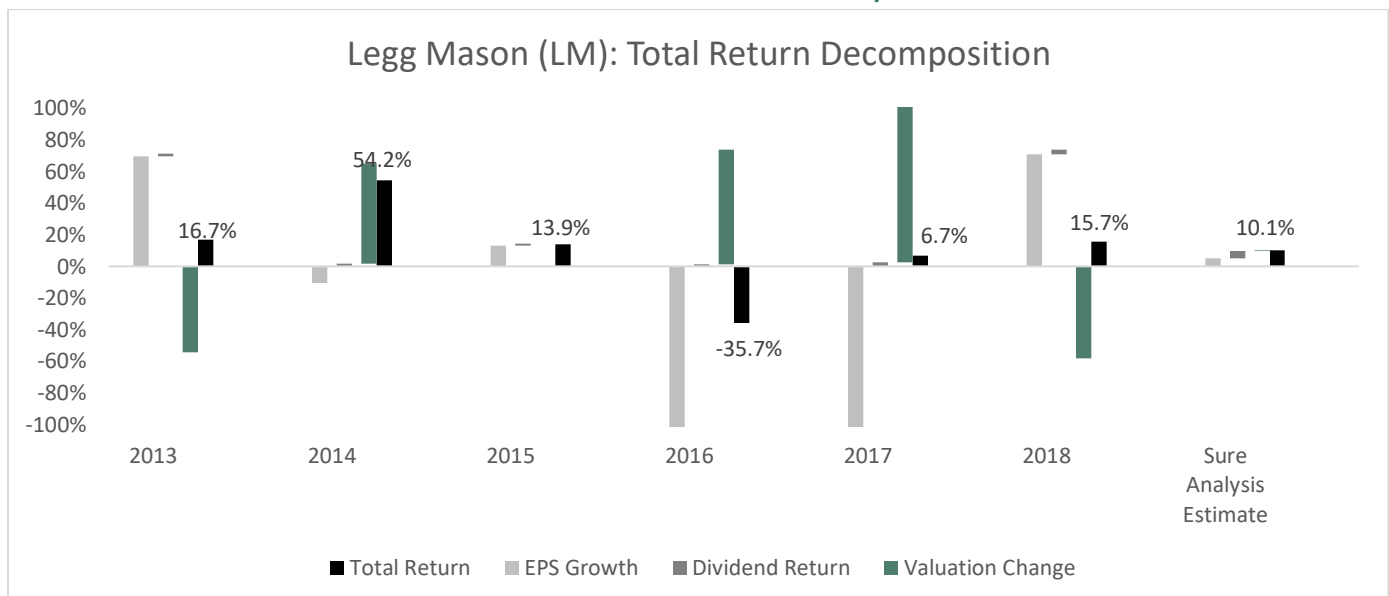
Legg Mason's recession record is volatile. Back in 2006 the company was earning \$4.50 per share and paying out a healthy dividend. When the financial recession came, the company lost \$13.85 per share and slashed its dividend from \$0.96 down to \$0.12. In turn, the share price fell dramatically from \$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 are still lagging. Legg Mason is likely to perform poorly during the next recession.

The payout ratio is reasonable, coming in at 42% 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.

Final Thoughts & Recommendation

Shares of Legg Mason are up about 11% since our last report, but earnings came in lower than expected. Moreover, 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. The security looks interesting from first glance, trading under 10 times earnings with a 4%+ dividend yield, but this comes with a fair amount of intermediate and long-term business risk. We rate Legg Mason as a hold currently.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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.

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