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LPLA - Q3 2017 LPL Financial Holdings Inc Earnings Call

EVENT DATE/TIME: OCTOBER 26, 2017 / 9:00PM GMT

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PRESENTATION

Operator

Good evening and thank you for joining the Third Quarter 2017 Earnings Conference Call for LPL Financial Holdings, Inc. Joining the call today are our President and

Chief Executive Officer Dan Arnold and Chief Financial Officer Matt Audette. Dan and Matt will offer introductory remarks and then the call will be opened for questions. The company would appreciate if each analyst would limit their questions to one question and one follow-up. The company has posted its earnings press release and supplementary information on the events section of investor.lpl.com.

Today's call may include forward-looking statements including statements about LPL Financial's future revenue, expenses and other financial and operating results; business strategies and plans, as well as other opportunities that management foresees. Such forward looking statements reflect management's current estimates or beliefs and are subject to risks and uncertainties that may cause actual results to differ materially.

The company refers listeners to the Safe Harbor disclosures contained in the earnings press release and the company's latest SEC filings to appreciate those factors that may cause actual financial or operating results or the timing of matters to differ from those contemplated in such forward looking statements.

During the call, the company will also discuss non-GAAP financial measures governed by SEC Regulation G. For a reconciliation of such non-GAAP measures to the comparable GAAP figures, please refer to the company's earnings release, which can be found at the company's website, investor.lpl.com.

With that, I will now turn the call over to Mr. Arnold.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Thank you, James. And thank you to everyone for joining our call.

Throughout an eventful quarter, we remained focused on our strategic priorities of growing our core business and executing with excellence. Consistent with our focus, we announced and closed our acquisition of NPH, which is an important milestone for us. Today I look forward to discussing the third quarter with you, starting with a summary of our results.

Our core business continued to grow in the third quarter with assets increasing to $560 billion, driven by increased net new assets and rising equity markets. Advisory net new assets were the primary driver of net flows, and as a result, 45% of total assets are now in advisory solutions.

On our centrally managed advisory platforms, net new assets continued to increase following our previously announced strategic pricing changes. Our advisor count was roughly flat in the third quarter as recruiting continued to be influenced by advisor uncertainty around the timing of the DOL fiduciary rule.

At the same time, production retention was 97% year to date prior to the impact of previously discussed client departures. Altogether, we believe our business results reflect the appeal of our model and our advisors' ability to win in the marketplace.

I'll next turn to our third quarter financial results. Gross profit was up year-over-year and we stayed disciplined on expenses to generate operating leverage. These results led to $0.63 of earnings per share or $0.66 prior to costs related to our NPH acquisition and our September debt refinancing. Matt will review our financial performance in greater depth. As we look forward, we plan to stay focused on driving growth and generating operating leverage.

I'd now like to review our approach to our NPH acquisition. Now as a reminder, NPH advisors are onboarding with us in two waves with one wave in Q4 and the other in Q1. Our onboarding approach for these advisors has two phases. The first phase is the recruiting process and the second phase is the transition onto our platform.

With respect to recruiting, we focused on four factors that we know from experience are important to advisors when moving firms. They are the ease of transition, their ongoing economics with us, our differentiated capabilities and our onboarding financial assistance. As such, I will address each of these in turn.

First, our tape to tape onboarding process enables a smooth experience for advisors and retail clients. Our process automates most of the account movement and paperwork and helps advisors maintain continuity in their service and revenue.

Second, in most cases, NPH advisors will continue to have similar take home pay with us as we have comparable payout grids to NPH.

Third is the strength of our capabilities and in particular, our advisory platforms and self clearing operations, which can support NPH advisors as they work to grow their practices.

Fourth, we offer attractive onboarding financial assistance, both in cash and other financial incentives, such as minimizing lost assets, avoiding revenue interruption and reducing out of pocket expenses. Altogether, we believe we are providing a compelling combination of process, economics, capabilities and financial assistance.

And we're approaching this with our principle of executing with excellence as we work to support advisors as they join LPL. As such, we are investing ahead of NPH advisors joining us in the two waves. As part of our plan, we anticipate hiring approximately 350 fulltime employees to help provide ongoing support to NPH advisors. We are also investing in a smooth transition experience by bringing on about 300 temporary staff to handle some of the initial work. At the same time, we are using innovation to reduce friction in the process and to deliver a more personalized experience.

In summary, we are taking a thoughtful approach to recruit and to transition NPH advisors to LPL. By early November, an advisor scheduled to onboard in the fourth quarter who does not wish to join us will need to notify NPH. This will give us a clearer view of the NPH advisors that will be included in the first wave on onboarding. As a result, we plan to share an update at our Investor Day.

I would next like to discuss our advisory solutions, where we continue to see strong demand consistent with broader industry trends. We have the competitive advantage of offering both corporate and hybrid advisory platforms. Our corporate platform is a turnkey solution that provides compliance, governance and operations and is a good fit for advisors of all sizes.

Our hybrid platform is designed for advisors and practices that have the size, capabilities and desire to operate their own RIA and take on the compliance work and risk themselves in exchange for a lower price. To ensure that our advisors join platforms that are designed to meet their needs, and to better align with the marketplace, in August we announced updates to our hybrid offering.

Starting January 1st, 2018, advisors and practices joining us will need to have $50 million or more of advisory assets to affiliate with our hybrid platform, though we will grandfather all existing hybrid relationships. These changes position us to allocate more capital in the form of transition assistance to advisors joining the corporate platform, which is well positioned to serve the emerging demand for risk management services in a more complex regulatory world. These changes also better align us strategically to work with advisor practices to both attract new advisors and new assets.

Now let us turn to the DOL fiduciary rule implementation. While we are planning for a January 1st, 2018 full implementation date, uncertainty remains on the final timing. At this point, we have already completed the majority of our preparation. The primary item that remains is the launch of our mutual fund only platform. Our plan is to bring this initiative to market directionally aligned with the final DOL rule implementation date. So we are staying flexible to adjust if the date changes. Regardless of the timing, we continue to believe a higher standard of care is appropriate and will benefit our industry.

In summary, we delivered another quarter of business growth and operating leverage. We closed on our acquisition of NPH and we are committed to smoothly onboarding their advisors. We plan to stay focused on our strategic priorities of growth and execution as we work to create long-term shareholder value.

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

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Thank you, Dan. And I'm glad to speak with everyone on the call. Overall, we are pleased with our third quarter results as we continue to improve our business fundamentals and financial performance by growing assets and gross profit, staying disciplined on expenses and driving operating leverage.

Year over year our assets grew 11%. Gross profit grew 12% and EBITDA grew 30%. We also announced and closed on our acquisition of NPH and are excited for their advisors to join our platform over the next two quarters. And we capitalized on favorable debt markets to borrow an additional $200 million, primarily to support NPH related costs and refinance some of our debt.

As for earnings, we generated $0.63 of GAAP earnings per share in Q3 or $0.66 prior to $0.03 of costs related to our NPH acquisition and debt refinancing. A year ago in Q3, we generated $0.58 of GAAP EPS or $0.42 prior to $0.16 of benefit from tax planning initiatives and account termination fees related to an institutional client departure. So prior to all of those items, our operating results drove EPS up 57% year over year.

Let's now go into our Q3 business results in greater depth, starting with brokerage and advisory assets.

We finished the quarter at $560 billion, up $18 billion or 3% sequentially, including $2.9 billion of net new assets. Demand for advisory services continues to grow as net new advisory assets increased to $6.9 billion, including $1.9 billion in conversions from brokerage to advisory.

Our net new advisory assets include centrally managed platform inflows that also increase sequentially. Those flows have averaged more than $1 billion per quarter this year, up from small outflows in 2016. These results show that our business is moving from brokerage to advisory and within advisory, more business is moving to our centrally managed platforms, both trends which benefit our gross profit return on assets.

Turning to our Q3 financial results, gross profit was $387 million, down slightly from last quarter. This is primarily driven by two factors, higher advisor production bonuses and lower annual IRA maintenance fees, both of which are seasonal trends we typically see in Q3.

Commission advisory fees net of payout were $96 million in Q3, down $8 million or 8% sequentially. This is mostly due to a higher payout rate, which was 87.3%, up from 86.4% in Q2 following a seasonal increase in advisor production bonus, as well as higher advisor stock compensation, given our Q3 stock price increase.

Looking ahead, Q4 is typically the highest quarter of advisor production bonus. For reference, it increased $2 million from Q3 to Q4 last year.

Moving on to asset based fees, which includes sponsor and cash sweep revenues. Sponsor revenues were $102 million, up slightly from Q2. As for cash sweep revenues, they were $82 million, up $10 million or 14% from Q2, primarily due to higher cash sweep yields following the June Fed rate hike.

Additionally, we launched our business ICA program in July and approximately $1 billion of cash balances moved from money market accounts to ICA. This provides insurance to more clients and increases our average cash sweep yield. Client cash as a percent of assets finished Q3 at 5.1%, flat with Q2. This is below our long-term average of about 6% as clients remained highly engaged in the market.

Looking at Q3 cash sweep yields, our ICA yield is 124 basis points, up 16 basis points from Q2. Looking ahead to Q4, we expect the primary driver of changes to cash sweep yields will be short-term interest rates. We also continue to expect that in each future Fed rate hike we can retain at least half of the benefit and generate at least $35 million of annual gross profit.

Now turning to Q3 transaction and fee revenues. They were $104 million, down $5 million or 5% sequentially. This was driven by $6 million in fees related to our Focus conference, partially offset by a seasonal decline in IRA fees.

Also, as a reminder, in Q2 we implemented an alternative investment custody fee effective at the beginning of 2016. So last quarter's revenue included fees for all of 2016 and Q1 of 2017, which totaled approximately $5 million. As we look to Q4, we don't have a major conference, so we expect conference revenue to decline by $6 million sequentially.

Let's now move to expenses, starting with core G&A. In Q3, core G&A expense was $179 million, including $3 million of NPH related costs. Prior to those NPH costs, core G&A was $176 million in Q3, flat with Q2 as we remain disciplined on expenses.

Turning to the full year, we now have three quarters completed and we feel good about what we have been able to deliver on expenses. For Q4, we typically have some seasonal increases in areas like client statements and professional fees, so we expect Q4 to increase sequentially, but when we look at the year overall, we expect core G&A prior to NPH costs to be in the range of $710 million to $715 million.

Moving on to Q3 promotional expenses. They were $43 million, up $11 million sequentially. This is primarily due to our Focus conference in Q3, partially offset by lower transition assistance. Looking ahead to Q4, we expect conference expense to be down by about $13 million. We also expect a seasonal increase in marketing expenses. For reference, marketing expenses increased $2 million from Q3 to Q4 last year. And as a reminder, Q4 is typically one of the stronger recruiting quarters of the year, so that could drive an increase in transition assistance and move promotional expense up.

Now let's turn to our September debt refinancing. Our business has performed well and debt markets have remained favorable. This created an opportunity to raise some funding, primarily for NPH related costs, further shift the mix of our debt from floating rates to fixed and lower our interest rates. With these opportunities in mind, we issued $400 million of add on senior notes to our existing senior notes from March. We were able to issue them above par with a yield of 5.12%, down just over 60 basis points from 5.75% just six months earlier in the year.

Of the approximately $400 million in proceeds raised, we used $200 million to pay down a portion of our term loan and we plan to use the remaining proceeds primarily for NPH related costs. We also lowered the interest rates on our term loan and revolver by 25 basis points each.

As we look forward to Q4, and assuming no change in interest rates, the net impact of the increased debt balance and lower yields should be an approximately $3 million sequential increase in interest expense.

Let's next turn to our leverage ratio. Our strategy is to maintain a strong balance sheet that positions us to take advantage of opportunities that arise much like we did with NPH. Last quarter we had a credit agreement net leverage ratio of 3.1 times. This quarter, our net leverage ratio is up slightly to 3.2 times, driven primarily by the $200 million debt increase.

In the long run, our management target leverage remains a range of 3.25 to 3.5 times and we continue to be comfortable operating slightly above or below that range to position ourselves to take advantage of opportunities as they arise.

Now let's turn to capital deployment. In Q3 our primary capital use was the $325 million initial purchase price for NPH. At the same time, we continued to invest for growth, providing transition assistance for recruiting and investing $27 million in CapEx, mostly for technology. We also continued to return capital to shareholders, including $25 million of share repurchases and $23 million in regular quarterly dividends for a total of $48 million in Q3.

As we look at our capital deployment options from here, we continue to see a number of opportunities that can drive growth and value for shareholders. More specifically, our near-term focus is ensuring that we are positioned to fund the incremental costs associated with NPH as well as potential opportunities, such as investing in our own stock as we believe it's an attractive investment at current trading levels.

Now let's talk more about NPH and its impact on our financial results. It is still too early in the process to share an update on our onboarding and retention progress, but I do want to give you a sense of how we are thinking about some of the financial impact.

First, NPH is going to increase our amortization of intangible assets. The transaction is structured to have a total purchase price in the range of $325 million to $448 million. We continue to expect to record this amount as a combination of intangible assets and goodwill, likely with slightly more intangible assets.

We also anticipate recording this amount on a pro rata basis as advisors onboard in the Q4 and Q1 waves. This means we will have some amortization of intangible assets starting in Q4, which will ramp up to the full run rate quarterly amount by roughly Q2 of next year. I would also note this estimate could change once we complete our valuation and accounting work.

Second, we continue to anticipate onboarding expenses related to bringing NPH advisors onto our platform in the range of $40 million to $60 million. This includes the $3 million of core G&A expense we had in Q3. We expect the remaining amount to be roughly split between Q4 and Q1 as we onboard the two waves of NPH advisors.

Third, we continue to expect roughly $100 million of onboarding financial assistance for NPH advisors joining our platform. While we expect more than half of our financial assistance to be loans, the amounts that are paid in cash would be expensed in Q4 and Q1 as advisors onboard. Just note that the actual amount of financial assistance we pay will be based on the amount of NPH business we onboard. So the final total may move up or down.

As for the timing of EBITDA benefits from NPH business that onboards, our view is unchanged. We expect to see some EBITDA benefits as advisors onboard in waves and to reach the full run rate benefit by the end of 2018.

In closing, we are pleased with our continued strong business and financial results. We are excited about our acquisition of NPH and we are working to provide a smooth onboarding experience for their advisors. We remain focused on growing assets in gross profit, staying disciplined on expenses to create operating leverage and deploying capital to drive growth and shareholder returns.

With that, Operator, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Yian Dai, KBW.

Yian Dai - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP of Equity Research*

First thing I had was on NPH and I remember when you guys announced the acquisition you talked about the cash levels for NPH clients being somewhat lower. And I guess I'm just wondering how you think about it and what's a reasonable timeframe to see those cash levels approach the LPL range as those clients onboard. What are the hurdles to getting to that point?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

This is Matt, I'll start. I think a couple of things and you see it in our mix of business as well. I'd highlight first, remember the mix of their business is more brokerage versus advisory, which is going to have their cash levels a little bit lower. And then two, I think when you look across our industry overall, clients in general are really engaged in the markets, so even looking at our numbers at 5.1% are relatively low by historic standards, which would put us around the 6% range. I'd highlight it was flat quarter over quarter, but I think it's client engagement's a big one and the mix of brokerage business is the other. And those are probably two things I'd highlight.

Yian Dai - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant VP of Equity Research*

And in your prepared remarks when you talked about the 350 fulltime employees and some of the temp staff, I'm just wondering what level of retention you're basing that on. Is it within that range that where you have the contingent payment?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes, this is Dan. I think as we contemplated and constructed our plan, we obviously shared with you the range of potential spectrum of retention that we were thinking about. So those numbers are just consistent with that plan. I think as Matt mentioned earlier, to the degree that you refine exactly what your retention rates will be, that number could potentially fluctuate up or down associated with that.

Operator

Doug Mewhirter, SunTrust.

Douglas Robert Mewhirter - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Just a quick numbers clarification. Your financial assistance, Matt, what did you say you estimated the initial financial assistance for the first two -- those two waves of advisors would be? You said about half of it would be in cash, but others would be loans, which would be amortized.

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Yes, so that was in reference to the approximately $100 million of financial assistance. So similar to Dan's comments on the headcount right now, that's our -- call it our middle of the road number and it could be above or below that. But it was in reference to that $100 million.

Douglas Robert Mewhirter - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

And my follow-up maybe for Dan. It's sort of two part, but the same subject on advisor productivity. I noticed the productivity for advisor ticked down. And also I noticed your sales commissions dropped off quite a bit and it looked like it was across the board, wasn't any one particular category. And I was just wondering related to both of those questions, just comment on advisor productivity in general or commission productivity.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes, and I think there's a small correlation there that obviously advisor productivity could be impacted relative to the amount of sales commissions that's being done. That productivity number also doesn't pull through in an apples to apples way the hybrid RIA advisory revenue because we don't count that as our revenue. That shows up as you know as more of an attachment revenue or the net revenue. And so the productivity numbers are a bit impaired or influenced, if you will, by not including that advisory revenue at a gross amount.

But I think the shift in the productivity numbers as you say it has a higher correlation with the sales commissions. And the sales commissions being down weren't a surprise to us. I think if you look at it, there's probably three primary drivers on the year on year change. The first is just that ongoing secular trend from brokerage to advisory. And where appropriate for clients we certainly want to be supportive and helpful in our advisors in making that transition, so we've tried to simplify and automate that process in that support. And again where it's appropriate for the investor. But that's one driver.

The second one is the standardization of commissions that went on across variable, fixed annuities and alternative investments. And again, that has a year on year impact where you see that showing up, then you're seeing a shift in the economics from less sales and more trails. And so I think that's part of that year on year impact.

And then finally the third one is one that's maybe more unique to us where some of the previously announced client departures that we had had a much higher mix of brokerage commissions and that would tend to create a headwind year on year.

I think if you look at it from a sequential basis from Q2 to Q3 that is really just the typical seasonality we see from coming in out of tax season or IRA season in to Q3. And I think the trend this year was very similar to the downward trend we've seen in prior years.

Operator

Steven Chubak, Nomura Instinet.

Steven Joseph Chubak - *Nomura Securities Co. Ltd., Research Division - VP*

I wanted to start off with a question on just rate and deposit beta expectations. If we look more holistically at just some of the rating deposit dynamics that we've seen in the retail brokerage space from some of your peers that have already reported, it seems that more of the benefits being passed along to clients, whether it's in the form of higher deposit rates or lower money market fees. I'm wondering if you're seeing any signs of intensifying competition on either deposits or money market. And maybe just some indications as to what sort of actions you might take to potentially combat some of those efforts.

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

This is Matt. I think when we look at specific to our cash product it's in general, it's rate insensitive, it's not unique to us. I think when you look at suite products in general they are about the operational convenience and availability to invest as opposed to a client putting money in there specifically for rates.

I think second, the first few rate hikes where interest rates didn't move. In the most recent one they did including us so I think you're definitely starting to see some of that rate sensitivity.

I think when you think about going forward from here, our working assumption is a 50% beta or pricing coefficient. We think it'll likely be, or possibly be a little bit better than that. And I think when you compare that across other folks in this type of products, I think the vast majority are assuming something at that or even lower. So I think we're pretty conservative in our view on the 50%.

And maybe the final point I'd make is it's not a certain pricing for all balances. Typically larger balances are more sensitive and the rates that get passed through on those are higher in general just due to the nature of the product. So I think we feel pretty good about where we're positioned.

Steven Joseph Chubak - *Nomura Securities Co. Ltd., Research Division - VP*

Just one more for me. It's maybe for Dan, just a broader question on the growth strategy. I'd say that one of the more interesting discussion points that we've had with investors post the NPH announcement has really been this discussion around the potential for rollups to become a bigger part of the growth narrative at LPL.

And I'm wondering if you view that growth strategy as something right for LPL to take advantage of. Just taking a step back, whether it's better economics at a self clearing entity and what appears to be a very fragmented broker dealer space, is there an opportunity that you view as sufficiently compelling and maybe providing the best return on capital or are you more looking to pursue that strategy because of the risks associated with M&A?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

That question certainly makes as a good one. So I would start right back at our strategy where we shared with you we're very focused on growing in our core markets and we see opportunity obviously to drive that through both organic growth in inorganic ways, such as M&A.

And I think that we approached the NPH transaction with very much a plan to make sure that we understand, that we learn, that we refine, that we are constantly working on how we improve that overall effort all in the spirit of that it could potentially be an ongoing opportunity. And you mix, as you say, a world that's getting more complex and tougher and challenging and scale tends to be more and more important in environments like that with a fragmented environment. And if we create a strong muscle around this overall effort and process then we think those things could add up to potential opportunity as we go forward.

Operator

William Katz, Citigroup.

William R Katz - *Citigroup Inc, Research Division - MD*

Just coming back to deposits made just from the other side. I actually heard a slightly different message from some of the online brokers. I think they're sort of coming in a bit lower in terms of their core deposit betas versus maybe some of the wire house oriented in their work channels. So when I look at that 50% deposit beta, that feels awfully conservative. Is that just sort of based on your own level of conservativism? Is there something very unique to your platform that would make your client base a bit more sensitive to rates? Just trying to get a better handle on why such a high percentage.

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

I think where interest rates go and where market dynamics go nobody knows. So I think you see a range of views on there. I think you've heard us, including today, every time we highlight this 50% beta emphasize that we think it'll be better than that. So I think you're hearing that well. I think getting into the nuance of whether it will be 40% or 30%, I think that's hard for us to know. So I think that's our perspective. We do think it's conservative, but again you never know. So that's our planning assumption.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

I think the only color I would add to that, and Matt referenced it earlier, is historically speaking these rates are different potentially across the size of the cash balance or the deposit in one's account. And I think you've heard us describe before the nature of our account balances are a lot of small accounts that historically have not been as sensitive to interest rates or competition as larger accounts. And so I think, as Matt said, it's uncertain, there's a lot of moving parts, but I think those are sort of the structural foundational elements that sort of shape our thinking.

William R Katz - *Citigroup Inc, Research Division - MD*

And just a follow-up. I was looking for your supplements and I know there's a lot of moving parts, but I was looking specifically at page 15. And I'm just so surprised that we're not seeing a little more lift in the gross profit ROA at this point in time. And I certainly appreciate some of the component pieces have changed here within brokerage, et cetera. But given where we are in terms of the rate cycle, given what seems to be a pretty healthy market backdrop and what's been a very strong operating leverage story in terms of the core G&A, I'm just surprised we're not seeing a bit of improvement there. Are we at a more natural inflection point or am I just missing something in terms of that sort of thought process on that incremental asset coming in the door?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

This is Matt. I think we've got a few decks out there, but I think you're in the investor presentation update on the operating leverage side. And I highlight a few things. First and foremost on us deliberating operating leverage, which is the difference between the gross profit ROA and operating expense. And I know you saw it, but just to emphasize below that, it is increasing and it's been increasing for the last three years. So we think that's good.

I think when you look at the revenues themselves with the gross profit ROA, there's a couple of things to keep in mind. So the trends that we've talked through for a while that Dan has emphasized as well, from a brokerage to advisory trend, and even within brokerage, the sales to trails conversion, those things manifest themselves in a decline and short-term revenues and then build in more recurring revenue over time. So I think you see that as part of the driver and I think the sales decline this quarter is a great example of that.

So I think we feel good about it, I think we feel good about the long-term growth opportunities, but I think we feel best about matching our investments and spending in those periods and delivering the operating leverage growth that you see on the bottom of that page.

Operator

Conor Fitzgerald, Goldman Sachs.

Conor Fitzgerald

Dan, just one for you. I know you don't have a better read on the hard numbers for November on the transition front, but just wondering if you could give us an update around what you're hearing from the NPH advisors in conversations and how they're finding your value proposition.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Appreciate the fact that certainly we're trying to get better numbers to share with you and be a bit more specific about that at Investor Day. That said, happy to give you some color leading into that.

So it's natural anytime you have an M&A scenario where it's a catalyst for advisors to consider their options. And I think we've shared that before. And so we anticipated this to be a competitive environment and so when we created the deal structure, obviously it was influenced with that anticipation in both the creating of the risk sharing within NPH, as well as trying to create a compelling value proposition for the NPH advisors. And again, I think we feel good about the combination of the things that experience tells us really matter to them, which is the transition process, getting from point A to B. Certainly the ongoing economics, to their business. And then finally the capabilities that we may offer them in a world that either lowers their costs, drives efficiency or helps them grow. And then finally, the financial assistance.

And I will say that, look, this a good property, good advisors and we certainly see many advisors who are excited about joining us and see that the opportunity of the capabilities, especially in the advisory area and the technology platforms of which to leverage to both drive efficiency and growth in their practices. So we see a really good positive response.

Of course the flip side of that is we didn't expect all NPH advisors to join us, so on the other side of that, not are all a good fit. And some may not be strategically aligned and wish to use all of our full set of capabilities. I think perhaps in other cases you might find one with a certain preference, such as perhaps a smaller firm. And then there's some cases where competitors have offered financial terms that just don't meet our thresholds. And I think what we've tried to do through this entire process in all cases is to maintain our financial discipline and our risk standards as we thought about the opportunity, just like we would do in typical recruiting.

All that said, we feel good that there's a compelling value proposition that's attractive to many of those advisors. And we look forward to providing more information to you at Investor Day.

Conor Fitzgerald

And then just one on the sponsorship revenues up 1% quarter over quarter versus total assets of 3%. Just wondering what the dynamics were this quarter and just how we should think about that kind of tracking versus asset levels going forward.

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

I look at it in two parts. I mean you've got revenue share in there, which is typically or mostly associated with the brokerage side of the business. In between the conversions from brokerage to advisory, and some of the outflows that we've seen over the last few quarters, that's driving that piece of other asset based revenue down.

And then the offset to that is on the recordkeeping side, which is primarily advisory driven, so that's growing in excess, as you can tell, with the 1% increase with the decline in brokerage, and that's connected to advisory growth and especially to growth on the corporate platform.

So those are the two dynamics there. Just the brokerage offsetting that advisory growth.

Operator

Devin Ryan, JMP Securities LLC.

Devin Patrick Ryan - *JMP Securities LLC, Research Division - MD and Senior Research Analyst*

In the investor presentation, I think on slide 16 you say lower near-term expense trajectory. And I just want to make sure I understand that. Is that just a comment on the tighter guidance range this year or is there some comment on expenses remaining low? I just want to make sure I understand that.

And then maybe a bigger picture on expenses, as you think about starting to budget for next year, how do you guys feel like you are in technology investment? I see the slide kind of showing the pretty big step up in CapEx in technology, which is good to see. But is that an area where you feel like it's going to be accelerating relative to other investments? Or how do you feel like that's an impact with trajectory over the next year?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

I think on the outlook in the investor slide there's no hidden message. It's specific to the 710 to 715.

I think on the technology front, I think our thought and philosophy here is unchanged and will likely be the same in 2018, which is when we think about investing for organic growth, I mean the two main areas we see are investing in recruiting and in technology development, primarily for development at capabilities for our advisors. And I think the slide you're referring to I think has us up in the mid-teens growth per year and we haven't landed our plans for 2018 yet, but I think there's that general trend is a good way to think about where we are focused, just because we see the value we see in investing in technology for our advisors and their clients.

Devin Patrick Ryan - *JMP Securities LLC, Research Division - MD and Senior Research Analyst*

Just a follow-up here. The FA headcount was essentially unchanged with last quarter. It was a little bit softer than my model and I know there's a number of moving parts in there, but is that just a function of not a lot of movement in the industry? Or is the gross number different, and I'm just kind of curious why movement may be stagnant or what you're seeing right now and just kind of bigger picture on just the recruiting backlog currently outside of what's going on with NPH.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

This is Dan. Let me take a stab at that for you. So if you look back I think over the last 12 months, right, you saw a good solid recruiting in Q4 and Q1. A bit softer in Q2 and Q3 tends to look a bit more like Q2. And I think the biggest driver that we see there is the continued uncertainty around the DOL rule. And that tends to reduce the amount of advisors in motion or movement, especially what we've seen in the financial institutions and larger practices.

I think we continue to see good flow of advisors out of employee based models to the independent model. So that's going on underneath that.

I think as we look at the combination of our capabilities and we continue to focus on growth and organic growth and recruiting being an important element of that, we think our model continues to be appealing. And that sets us up well to think about our long-term outlook for expanding the number of advisors through recruiting.

I think your final question around is there some NPH overlap into our overall recruiting effort. In the short-run, we treated those items as two different initiatives and we tried to thus separate the resources associated with executing on both of those to mitigate much of the disruption as we could.

Now the leadership team that's overseeing those efforts is our recruiting leadership, who's over indexed some of their time in the last couple of months to NPH, so that might have some minimal or marginal impact in the short run. But we think with the acquisition of NPH ultimately becomes a stimulus to increase recruiting as it just expands our incremental capacity to invest.

Operator

Christopher Harris, Wells Fargo.

Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

You guys have had gross margin up around 12% over the last couple of quarters and I'm wondering what you think your growth rate would be if we are in an environment of flat rates and flat equity markets.

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

So we don't give guidance there. I mean I think I go back to the earlier question on [inaudible] margin, it's really about what we're driving to grow their business outside of interest rates. So thinks like brokerage to advisory conversions. The investments we're making in the advisory platform. Aligning our policies, as Dan talked a lot about today, to match up that advisory platform, both the corporate platform and the hybrid platform with what folks need in the market. I think those are all the areas that if we're successful over time are going to drive returns and increase returns in gross profit in addition to increases in interest rates or market levels overall. And of course net new assets themselves. So that's what I highlight. Nothing else.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

I think that's right. We continue to stay focused as Matt said on driving organic growth, exit that either market tailwind or headwind. And I think we've described how we typically do that and there's a variety, as you say, of moving parts inside of that, but if we can continue to grow net new assets and improve and enhance the ROA on those assets, then we'll execute on that effort.

Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

A bigger picture question for you. You've made a lot of changes in the platform over the last couple of years. Are there any other major initiatives left at this point or do you guys think you've done most of the heavy lifting?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Maybe there's a couple of platforms that you're referring to. So perhaps the first one is the operating platform, which we refer to as client works. Is that what you're referring to?

Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

Yes, I just meant the overall the organization. So whether you've made significant pricing changes, the upgraded technology and so on.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

I think we continue to invest in the business where we see strategic opportunity. So we're always looking at the environment and looking for trends, issues, challenges, opportunities and where we can be most thoughtful about evolving our capabilities to capitalize on those opportunities. And so price is always one of those considerations. It could be new services that may drive new revenue streams. It could be investing in technology to drive new capabilities, as Matt said earlier, to help position our advisors to win. And so I think you will see our effort on a go-forward basis as it has been in the last couple of years to continue to enhance the model and capitalize on the opportunity in the marketplace.

We think there is a great opportunity with the growing demand for financial advice to continue to position and help our advisors step in and capitalize on that opportunity. We think the independent objective advice is the best approach to doing that, so we think our model has lots of merits as well to attract new advisors to it. So I hope that answers your question. But from a big picture standpoint, you should expect us to continue to invest in our capability set to try to capitalize on that opportunity.

Operator

Christopher Shutler, William Blair.

Christopher Charles Shutler - *William Blair & Company L.L.C., Research Division - Research Analyst*

On the transaction and fees line, I just want to dig in there why a decline $5 million quarter over quarter in Q3. I know there was the $5 million or so of one-time help in Q2 from Alt. There was $6 million, I think, roughly benefit from Focus in Q3. We also know kind of the online brokers that their darts were flat to up in Q3, so I guess all else equal, I would have thought that line would have been closer to flat than down $5 million.

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

You summarized it pretty well, Chris. I mean I think the only item you didn't have there is more, and Dan covered it a little bit earlier on the IRA side. So seasonality for IRA fees and things is really in the first half of the year and especially in Q2. And you would typically see a decline in that in Q3. So that'd be the third piece and the other two big ones you highlighted. The Focus conference and the AI custody fee in the prior quarter.

Christopher Charles Shutler - *William Blair & Company L.L.C., Research Division - Research Analyst*

And then regarding this whole move to require new advisors to put $50 million on the platform, could you just walk us through the thought process there, the puts and takes? On one hand, there's potentially increased attrition from OSJs, on the other hand you get better economics from new advisors. So just how did you come up with that solution?

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

So I think maybe the question is hey, what's our strategy or how are we thinking about that, right? And so with context, we, as I mentioned earlier, we offer both a corporate and hybrid platforms, which is a competitive advantage, it enables us to serve a greater diversity of advisers. And that's a good thing and hence we're committed to continue to investing and growing both platforms.

I think as such, you have to pay attention to also the growing trends out in the marketplace. One that we see is the complexity in the regulatory world is driving a greater demand for risk management services and support. And of course, our corporate platform provides those capabilities. In fact, a little more color on that, some of the advisors that originally went hybrid back three and four years ago are now, because of the change in the risk management elements of their business, are now in the process of moving back to the corporate platform and we expect some of that trend to continue.

And so in that spirit, I think we were focused on two key principles with this update. One was to align our offering to what is available elsewhere in the marketplace. And the second is positioning ourselves to allocate our capital in line with our economics. So beginning in 2018, advisors under $50 million of advisory assets will join the corporate platform. Advisors that have over $50 million have the choice of joining either the corporate platform or the hybrid platform. And then secondly we'll provide greater transition assistance rate on corporate advisory and bring our hybrid TA rates down in line with the marketplace.

And we believe these changes will position our advisors to best capitalize on the market opportunity going forward where we help them both in terms of serving their existing clients to give them more time to grow their practices. And secondly, where we will continue to help and support them recruit new advisors to their businesses.

So that's the overall why we did this. We actually thus think in the long term this will actually help our recruiting volumes and certainly as you said, it'll create higher yield on those recruiting classes as we get a better return because we provide more services on the corporate platform.

Operator

Kenneth Worthington, JP Morgan.

Kenneth Brooks Worthington - *JP Morgan Chase & Co, Research Division - MD*

Actually just a follow-up on the transaction line question. The seasonality you guys mention in IRA fees, hasn't that always been the case? Why so unusually pronounced in 3Q '17 versus the second half of prior years?

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

I wouldn't say it's so pronounced. I think when you, and maybe when you look at the year over year that looks like it's pronounced, but a reminder the Q3 2016 had some -- around $4 million in termination fees associated with a client departure in that quarter. So I wouldn't say it was abnormally larger than we've seen in the past.

Kenneth Brooks Worthington - *JP Morgan Chase & Co, Research Division - MD*

And just on the custom clearing providers, that number was down again. Just talk about what the outlook there is. Is there sort of a light at the end of the tunnel on the advisor's number there? And then how profitable is that sort of segment for you? My impression was it wasn't very profitable, but maybe a little help there too.

Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

I think on the trends, I mean I wouldn't read anything into it. We've got a large client there and a couple smaller ones and we've had on the smaller side some movement out that has shown those numbers or had those numbers come down. I wouldn't translate that into any profitability concerns, it's really just some noise in those numbers and it's really one large client that drives that.

Kenneth Brooks Worthington - *JP Morgan Chase & Co, Research Division - MD*

But I assume growing that number is better than shrinking that number. Is there an explanation as to why it's shrinking? And this quarter may be in just the trend has been shrinking there.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Yes, this Dan. I think to the degree that number is really driven off of the prioritization of that client and their strategy with their own broker dealer. And whether or not they're in a mode of expanding and then growing it through recruiting could influence that. There could be some noise in that with smaller advisors being transitioned out, et cetera. So there's some probably bigger drivers of that associated with their strategy.

I think what we continue to see and work on is enhancing the assets per advisor that we serve in that area and helping them continue to evolve their practices where they're leveraging more advisory and brokerage solutions in their overall efforts. And that's how we see the opportunity of growing and expanding that overall relationship.

And we continue to strategize with them about how we might support and help them with respect to any number of different growth initiatives they may be contemplating. But at the end of the day, they're the ones that would decide what initiatives they prioritize and invest in.

Operator

Michael Cyprys, Morgan Stanley.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

Just curious if you could talk about your perspective on advisor payouts or payouts to new advisors that are coming onboard. Just how that is evolving and if you were to look at three years how things may look different in three years from today. How you see this evolving.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Let me try to answer that for you and if I don't answer it completely, please add on to it, your question. But look, so I think that that number is influenced by the mix of business that you do, so your advisory business versus a brokerage business. I think given the positioning of our payout grids, we've been very competitive and kind of an industry leader with respect to both the payout we provide in exchange for the value we deliver on that payout. And we've seen stability in those numbers other than some of the mix shift that has occurred.

I think where you've seen us think about pricing as a strategic lever is more where the flows are going and that would be in the advisory area in the advisory world and where we've tried to potentially bring down the cost associated with our centrally managed platforms, to make sure that that is a great trade for the advisor for those incremental services, for the incremental payment that they make for them and the return they get on that in terms of freeing up their time to do other more productive things. And I think it's fair for us to continue to think about pricing in that way, how can we continue to bring down the cost of our corporate advisory platform to enable those advisors to leverage more of those services and position themselves both to provide greater investment content more efficiently to their clients at a lower cost.

And so that's how I would think both about the stability of the overall payout and how it may be influenced by potential pricing in the area of advisory platforms. I hope that helps you.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

And just as a follow-up question, I think earlier you mentioned new services and capabilities that could make sense to add to your platform to help your advisors. Just curious if you could help flesh that out in terms of what types of services, what type of capabilities might make sense.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

So they would be focused in two areas. One is how do we help improve the investor experience? At the end of the day, we've got to make sure that we provide them the capabilities that they need to solve their problems at the service levels they expect, all at a competitive price.

And so I think with respect to the investor experience that can be anything from new statements that we delivered and provided, as an example, in the second half of the year and we continue to evolve those, all the way to how do we enhance and improve the digital experience that's delivered to the end investor? Or that could show up in the form of products and platforms, like lower costs for our centrally managed platforms, adding new investment content to those platforms or even the changes we made in the SMA platforms by bringing in a lot of low cost investment content and options to them.

So those are examples of where we would continue to invest to help the advisor position themselves to win with the investor. And I think with respect to the advisor, it's anything that we can do to lower the cost of their practice to increase and enhance the scalability of their business or to support or help them grow it.

So you could look at any variety of things, like a suite of virtual services. A great example would be the virtual admin that we rolled out at Focus this year, which is intended to cut in half the cost of an admin for them that gives them a productive resource that knows our systems, takes friction out of the system and provides some technology interface to create a personal experience around that. That's a great example of a new service that would lower their cost and create scalability in their practice. So again you see that with overlay trading capabilities, evolving our advisory platforms. You'll see it with new technology that will drive straight through processing and again reduce the amount of effort and time they spend on administrative work. So not to belabor the point, but those are examples of how we think about that.

Operator

That does conclude our Q&A portion for the call, so I'd like to turn it back over to Mr. Arnold for closing remarks.

Dan H. Arnold - *LPL Financial Holdings Inc. - CEO, President and Director*

Thank you. And I just wanted to thank everyone for taking the time to join us this afternoon. And as a reminder, our Investor and Analyst Day is on November 8th and we look forward to speaking with you then. Have a great day.

Operator

Thank you, ladies and gentlemen. That does conclude today's conference. Thank you very much for your participation. You may now disconnect. Have a wonderful evening.
