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EDITED TRANSCRIPT

LPLA - Q4 2017 LPL Financial Holdings Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 01, 2018 / 10:00PM GMT

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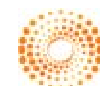

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PRESENTATION

Operator

Good evening, and thank you for joining the Fourth 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. (Operator Instructions) The company has posted its earnings press release and supplementary information on the Events section of the investorlpl.com. Today's call may include forward-looking statements, including statements about LPL's financial future revenue expenses and other financial and operating results, business strategy 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'll now turn the call over to Mr. Arnold.

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

Thank you, Sheree. And thank you to everyone for joining our call. In 2017, we were focused on our strategic priorities of growing our core business, executing with excellence and capitalizing on market consolidation opportunities. We feel good about the progress we made on our strategic priorities as we grew organically, acquired NPH and delivering operating leverage, while also benefiting from a favorable macro environment.

Let's first turn to our business results. We finished the year with $615 billion in assets, up 21% from 2016 and up 10% from the third quarter. This was driven by a combination of organic growth, market appreciation and the initial movement of NPH-related assets. Looking further at fourth quarter, total net new assets were $37 billion, including $3.3 billion of organic net new assets and $34.2 billion in assets from NPH.

Additionally, the secular trend from brokerage to advisory continued, as advisory assets increased to 44% of total assets. This was largely driven by net new advisory assets of $6 billion in the quarter, including $1 billion of net new centrally managed platform assets.

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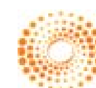

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In Q4, our adviser base grew by 957, primarily driven by NPH wave 1 advisers. For the full year, prior to the impact of NPH, and previously announced departures, we added 98 net new advisers and production retention remained high at 97%. For some additional color, we recruited approximately $25 billion of new assets for the year, some of which will onboard in 2018. We believe our core business growth demonstrates the appeal of our model and our advisers ability to win in the marketplace.

Now, let's discuss the 2017 financial results that were generated from this business performance. So for the full year, gross profit increased 12% while core G&A was up less than 2% prior to costs related to NPH. EPS prior to the financial impact of NPH and tax reform, was $2.75, up 29% from the prior year and our full year GAAP earnings per share were $2.59. Matt will review our financial performance in greater depth.

Next, I want to provide an update on our NPH acquisition. Onboarding the roughly 1,000 wave 1 NPH advisers has been a priority for us. We have been working hard to create a smooth transition process. So they are positioned to leverage the full breadth of our capabilities and thrive at LPL. At the same time, we've been eagerly preparing for wave 2. And we are excited to have approximately 1,000 more advisers joining us for a total of roughly 2,000 advisers. Additionally, this acquisition has been a catalyst to drive innovation in how we bring advisers onto our platforms. And the greater scale from NPH increases our capacity to invest in technology and new capabilities, which is a benefit to all of our advisers.

Now let's turn to some of the highlights of our NPH progress to date. In December, all wave 1 advisers transitioned to our platform, along with most of their assets. The remaining assets will transfer to LPL in the first quarter. Wave 2 is scheduled to onboard later this month and is roughly the same size as wave 1.

Overall, we estimate production transfer of approximately 70% with EBITDA equivalent to around $85 million. We have an opportunity to grow EBITDA further as we continue to work with these advisers to fully leverage our advisory platforms, technology tools and other capabilities to help their practices grow and thrive.

Now that we have reviewed our 2017 results, I'd like to discuss our strategic priorities for 2018. We remain focused on growing our core business, executing with excellence and exploring M&A opportunities, if they arise. Starting with growth, we want to help our advisers operate thriving practices with differentiated services that win in the marketplace. To help achieve this goal, we see additional opportunities to evolve our capabilities and services. Our technology solutions are a key component of many of these initiatives and an increasingly important differentiator for our value proposition.

Over the last several years, we have expanded our technology-related investments by 16% annually to over $100 million last year. We also plan to continue increasing our investments in 2018 at a similar rate. This includes: Ongoing work to evolve key platforms like ClientWorks and delivering a new digital experience for investors. We will also rollout our new virtual services, which enable advisers to outsource more functions and help enrich their execution. This will allow our advisers to spend more time with their clients and grow their business.

Additionally, we will continue investing in our brokerage and advisory platforms and other services that help our advisers meet the growing and changing needs of their clients. In summary, delivering these enhancements is intended to benefit our advisers through increase scale, lower operating costs and enabling growth. We are excited about the opportunities we see to leverage our unique model and help support our advisers.

We also continue to believe our industry is positioned for consolidation. M&A can drive meaningful long-term value and complement organic growth. Our work with NPH reinforced this view. So while we are focused on smoothly onboarding NPH now, we are also positioned to take advantage of future opportunities as they arise.

Now let's turn to our second strategic priority, executing with excellence. Aligned with this, we remained committed to delivering results and staying disciplined on expenses, while executing on our key initiatives. One of our top priorities for 2018 is making it easier for advisers and their clients to do business with us. We are focused on creating a simple operating environment for our advisers. To do that, we are modifying our training and incentive programs, simplifying our policies and procedures, leveraging technology to take the friction out where it exists, and providing relevant information when and where an adviser needs it. This becomes a larger opportunity as our adviser base now exceeds 15,000. Given the strength of our results and the current macro environment, we believe we can increase our investment in both growth and execution initiatives, while still delivering operating leverage.

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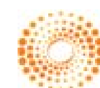

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Before closing, I want to discuss 3 environmental factors specific to 2018. First, Congress passed tax reform that benefits both our business and our advisers practices. For LPL, the reduction in corporate tax rates will benefit our financial results and Matt will cover this in his remarks. Our advisers, many of whom have structured their practices as pass-through entities, may also be able to benefit from lower taxes. We believe this will both strengthened their earnings and position them to invest in more growth. We also think this will further strengthen the appeal of the independent channel and our model. Second, the Department of Labor delayed the full implementation of its fiduciary rule until 2019. The SEC is also contemplating a rule and we continue to believe a higher standard of care is appropriate and will be fully implemented at some point in the future. We think the changes we have already made across our platforms will help advisers better support their clients and differentiate their businesses.

Third, there has been a lot of discussion about the broker protocol, lately. We believe providing choice is important. And we think the protocol enhances choice, which is good for advisers and investors. So we plan to stay in the protocol and we hope to see other members stay in as well.

In summary, we feel good about the business and the earnings growth we delivered in 2017. We plan to remain focused on our strategic priorities of growing our core business and executing with excellence. We believe our strategy positions us well to serve and support our advisers, drive profitable growth and 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 today's call. Q4 capped off a year of continued business and earnings growth. And we are pleased to have delivered strong financial results in 2017. We grew assets organically, acquired NPH, stayed disciplined on expenses to drive operating leverage and completed 2 debt refinancings. As a result, Q4 EPS prior to the amortization of intangible assets, was $0.76, up 46% year-over-year. And prior to the impact of NPH and tax reform, was $0.89 up 71% year-over-year. As for operating leverage, we increased our Q4 EBIT ROA prior to NPH by 38% year-over-year.

Let's now go to our Q4 results in greater depth. Starting with brokerage and advisory assets. We finished the quarter at $615 billion, up $55 billion or 10% sequentially, driven by organic growth, NPH onboarding and market appreciation. Total net new assets for the quarter were $37.5 billion, including $3.3 billion of net new assets prior to NPH and $34.2 billion assets onboarded from NPH. Of those NPH assets, $26.6 billion were brokerage and $7.7 billion were advisory.

I also want to provide an update on our overall asset expectations for NPH. When we announced the acquisition, NPH reported about $120 billion in total assets, which included about $15 billion of advisory assets that were held with third-party asset managers or other custodians. While these assets will transfer with their associated advisers, we do not include off-platform assets in our metrics. So they will not be included in our reporting. So prior to applying our estimated transfer levels, NPH reportable assets were $105 billion.

With that as the starting point, let's look at how much we expect transfer to LPL. Overall, we estimate production transfer of about 70%. While we expect this will lead to an EBITDA equivalent of about 80%, or $85 million, we also anticipate it will lead to an asset transfer range of 65% to 70%, or roughly $70 billion to $75 billion of total NPH reportable assets joining our platform. We expect the majority of these assets will transfer by the end of Q1 with the rest joining in Q2.

Turning back to our Q4 results. Our advisory services continue to grow as net new advisory assets were $6.3 billion prior to NPH, which included $2.1 billion in conversions from brokerage to advisory. This also included $1.4 billion in centrally managed platform inflows.

Moving to Q4 gross profit. It was $403 million, up $16 million or 4% from last quarter. This was primarily driven by increased commissions and advisory fees as well as higher interest rates. Additionally, NPH advisers started to ramp up their businesses in December and contributed roughly $4 million.

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Commission and advisory fees net of the payout were $104 million in Q4, up $8 million or 8% sequentially. As sales commissions, trailing commissions and advisory fees all increased. Sales commission growth was mostly driven by variable annuities, along with increases in mutual fund, equity and fixed income.

Looking ahead to Q1, we previously announced that we will lower the cost of our corporate advisory services, effective January 1. As a reminder, this will reduce gross profit by about $3 million per quarter initially. We believe the improved pricing will attract additional assets to our corporate platform, which would offset this cost over time. As for asset-based fees, which includes sponsor and cash sweep revenues. Sponsor revenues were $105 million, up $3 million from Q3, primarily driven by higher equity markets.

Moving to cash sweep revenues, they were $88 million, up $7 million or 8% from Q3, primarily due to increased cash sweep yields. Client cash as a percent of assets finished Q4 at 4.8%, down from 5.1% in Q3 as investors remained highly engaged in the NPH assets that onboarded had lower cash as a percent of assets. Looking at Q4 cash sweep yields, our average yields increased driven by the mid-December rate hike, while money market yields were relatively flat as they had already reached their cap. As we think about Q1, we will have the full quarter benefit of the December rate hike, but we also increased our ICA deposit rates by an average of 4 basis points towards the end of January.

Assuming no further changes in fed rates, or our deposit rates, we anticipate Q1 ICA yield to be in the mid-140 basis point range.

Now turning to Q4 transaction and fee revenues. They were $103 million, down $1 million or 1%, sequentially. Recall that Q3 included $6 million in fees related to our Focus Conference. So prior to those, transaction and fees were up $5 million sequentially driven by higher transaction revenues and seasonal IRA account fees.

Let's now move on to expenses. Starting with core G&A. In Q4, core G&A expense was $195 million, this included $7 million of NPH onboarding cost and $5 million of NPH run rate costs. Prior to those NPH costs, core G&A was $183 million, up 4% sequentially, primarily driven by an increase in technology projects and seasonal items such as customer statements.

For the full year, core G&A prior to NPH costs were $712 million, a growth rate of about 2%. Looking forward to 2018, we plan to stay focused on productivity and efficiency and we see opportunities to invest for organic growth, especially given the combined benefits of the current macro environment, tax reform and our NPH acquisition. Therefore, we plan to increase our core G&A growth rate prior to NPH to around 3% to 5% for 2018.

For an outlook range of $730 million to $750 million. We believe this level of investment provides the right balance of investing for organic growth, while still delivering operating leverage. As for 2018 core G&A from NPH, we expect both onboarding and ongoing costs, which we estimate to total $70 million to $80 million. Taking all that into account, we expect 2018 core G&A, including NPH, to be $800 million to $830 million. As for Q1, we expect it to be one of the higher quarters of the year, primarily due to NPH onboarding costs. I would also note that the core G&A from NPH is inherently more variable than the rest of our core G&A. As it is largely driven by the timing of NPH business ramping with us. That may impact the timing and amount of our total 2018 core G&A expense, but we do not anticipate that it will impact our run rate EBITDA estimates.

Moving on to Q4 promotional expenses, they were $60 million, including $23 million of NPH-related costs. Prior to those NPH costs, promotion was $37 million in Q4, down $6 million sequentially. Increased recruiting drove higher transition assistance, but this was more than offset by an $11 million decline in conference expenses as our largest adviser conference was in Q3. As for the NPH-related promotional expense in Q4, it was mostly driven by onboarding costs and financial assistance.

Looking ahead to Q1 promotional expense, prior to NPH, we expect our costs to be primarily driven by transition assistance for organic recruiting, which varies quarter-to-quarter, that we also expect an additional $1 million for our Summit Adviser Conference. For NPH costs, we anticipate an increase of $10 million to $20 million sequentially, though actual results could vary depending on the final amount and mix of cash and loan assistance for wave 2 advisers.

Turning now to regulatory expenses, they total $5 million for Q4 and $21 million for the year. As we think about 2018 expenses, I want to highlight a few things. First, we included about $5 million of regulatory expense in our NPH run rate EBITDA estimates. As a reminder, we have a captive

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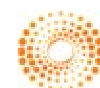

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insurance company that cover cost of regulatory matters that may emerge, such as SEC, FINRA in state securities laws matters. And the $5 million for NPH is primarily to increase our captive coverage to align with our greater size and scale. And of course, I would be remiss if I didn't emphasized that the nature of regulatory expenses makes them inherently difficult to predict. So our actual expense could move up or down in any given year based on the size and timing of matters and available captive coverage.

As for share-based compensation, it was $4 million in Q4, down $1 million from the prior quarter. As we look ahead, Q1 has historically been the highest quarter of the year and that is when annual grants occur, and we anticipate approximately $6 million of expense next quarter.

Looking at depreciation expense in Q4, it was down $2 million sequentially, primarily due to the onetime expense we had in Q3 from consolidating our Boston office space. Looking ahead to 2018, we expect depreciation expense to increase roughly in line with the 10% growth we saw last year, driven by technology investments.

Moving to amortization of intangibles. It was $10 million in Q4, up about $1 million sequentially due to NPH. Using our estimate of 70% production transfer, we anticipate total amortization of intangibles would build to roughly $16 million per quarter by Q2.

Turning to taxes. Our Q4 effective tax rate was 20%, well below our normalized rate of just under 40%. This was primarily driven by 2 factors. First, we generated a benefit of 11 percentage points from tax reform, as we are in a net deferred tax liability position and we wrote down those liabilities to the lower rates. Second, we had a 7 percentage point benefit from our estimated state tax rates from prior years, which ended up being lower than what we had estimated. As we look ahead to 2018, we expect our effective tax rate to be in the 27% to 29% range. We estimate a net benefit of roughly 12 percentage points from tax reform as the 14 point reduction in corporate tax rates will be partially offset by some deductions that were eliminated. Also, the benefits of tax reform increase our estimated EPS accretion from NPH.

We had originally estimated that $85 million in run rate EBITDA would generate about $0.47 EPS accretion prior to amortization of intangible assets. Including the benefits of our lower corporate tax rate, that EPS estimate would increase to around $0.56.

Moving on to capital management. Our balance sheet remains strong with our net leverage declining to 2.8x. Turning to capital deployment, cash available for corporate use was $439 million, down $75 million from Q3. This was primarily driven by NPH wave 1, both financial assistance and onboarding costs as well as some large prepayments we typically make in Q4 like our insurance premiums and registration and licensing fees. We also returned $53 million to shareholders, including $30 million of share repurchases and $23 million in regular quarterly dividends.

Looking ahead, with NPH coming onboard, the strength of the macro environment and tax reform, we expect our cash flow generation to increase. Our primary focus remains investing for organic growth, and we plan to deploy more capital into recruiting and technology. As we think about deploying capital beyond that our approach remains the same. We plan to be disciplined and deploy capital wherever we believe it drives the most long-term value, including taking advantage of M&A opportunities if they arise and returning capital to shareholders through share repurchases, as we believe our stock is an attractive investment at current trading levels.

Finally, as we work to provide you with more insight into our business, we added new asset disclosures this quarter on our corporate advisory and centrally managed platforms, which we hope you find helpful. We also posted a historical file with these metrics for your reference on our Investor Relations website.

In closing, we are pleased to have delivered strong business and financial results for Q4 and 2017. We remained focused on growing assets and 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.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Bill Katz with Citi.

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

And also for the expanded disclosure. It is helpful. One of the topics, I think, that has been sort of weighing on the stock more recently or just more generally is just the whole discussion of core deposit beta. And I certainly appreciate your guidance for Q1 yields, but just want to stepping back. Can I have a little bit more time to sort of look at the NPH platform as well as your own platform? But can you give us your latest thinking about how you sort of see maybe the terminal level of core deposits, and when you might get there?

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

Yes. Sure, Bill. And I think -- are you speaking to the balances and rates together? I can cover both of them.

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

Well, I was really geared to the rates, but if you want to add color on the balances, absolutely happy to hear that, too.

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

Yes. Sure, I think the primary area of focus is on the rates. So I'll start there. I think our view of deposit beta hasn't not changed, right, our long run outlook is in the 25% to 50% range. I think when you look at the rate hikes that have happened since the cycle started, in 2 years ago, deposit betas were basically for the first few hikes for most folks were around 0, when you look for -- look at us, that has been similar. When you look at the last few, it's been in the 5% to 10% range. I think probably the most tangible data point is when you look at our most recent rate change and hike. The beta I'd say was around 15%. So we're still below the low end of that range that we have. But I think that's still the best thinking. I'd be remiss if I didn't highlight, when you just look at the industry as a whole, when you go back to the peak of the last rate hike cycle, those betas average about 20%. So I think, we're -- we feel good about our deposit betas and pricing. I think the balances themselves, I think you're seeing them at historic lows. And I think it's a high-class problem that investors and their advisers are highly engaged in deploying those funds into the market. And I think that's why you see them relatively low right now.

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

Okay. It's helpful. And then just sort of follow-up, may be stepping back, obviously, you're still in the midst of onboarding both wave 1 and wave 2 coming up. And you mentioned your capital management priorities. But just as you sort of think about the M&A backdrop versus the uses of cash, where our conversations now beyond NPH in terms of [DPO] potential, have things advanced in any way relative to what maybe for the Investor Day? Or is the primary focus getting these waves in, and then sort of reaccessing these gains in the second half of the year. I'm just trying to understand how do you sort of deploy this excess step-up of free cash flow?

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

Yes. So Bill, it's Dan. Let me at least take the -- I think the conceptual question or the strategic question, and then certainly, if there is a drill down on the actual capital and how that translates, I'll certainly happy to let Matt add color. But I think as we think about it, it hasn't changed from what we said at Investor Day and it's probably the second scenario where we are very much focused on ensuring that we integrate in the advisers and the assets from the NPH transaction. I think we remained focused on that. What we've said is probably, that operational capacity, if you will, increases

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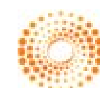

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the second half of the year. And I think that's when we would be ready more from an operational standpoint to explore potentially another transaction. I think from a financial standpoint, or a capital standpoint, as Matt alluded to earlier. We, obviously, as we look at that feel prepared in position today. And ultimately, you want to align those -- both of those things up.

Operator

Our next question comes from Conor Fitzgerald with Goldman Sachs.

Conor Burke Fitzgerald - *Goldman Sachs Group Inc., Research Division - VP*

Just on the core G&A guidance, including NPH, can you give us a sense of how much of the $70 million to $80 million is onboarding versus more recurring costs? And as a follow-up to that, is the right way to think about long term, not that I'm asking for 2019 guidance, but as you just think about your expense trajectory in 2019, would it be building off of your 2018 all-in level or 2018 minus the onetime costs?

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

Yes. Conor, this is Matt. We didn't break up the onboarding versus the ramp. I think we'll break that out in future quarters as it comes on and try to emphasize that in the prepared remarks because it all depends on the timing of when things pull through. I think when you -- on the second part of the question, when you look ahead to 2019, I think the probably the best way to think about our investments for organic growth is just looking at the past few years. I think when we've been focused on a bit of a challenging macro environment and really delivering bottom line operating leverage, we've been in that 0% to 2% growth range. I think when we look ahead to 2018 with a number of factors lining up to increase our cash flow, combined with when you look at the opportunities to invest to really help advisers improve the capabilities we delivered to them for them to drive their practices, those 2 things together, I think are in a great place this year, which is what led us to think that 3% or 5% growth rate make sense. So those are the -- maybe just thinking about those 2 types of environments, so it just depends on what type of environment we're in 2019. We'll guide our thoughts there.

Conor Burke Fitzgerald - *Goldman Sachs Group Inc., Research Division - VP*

And then on the noncash asset-based fees up nicely quarter-over-quarter. Could you help us understand how much of that was from the benefit in NPH assets? And then longer-term, do you feel like based on what you can kind of see today, that level should start tracking more in line with asset growth? Are there any other headwinds that we should be focused on?

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

Yes, so if you're talking about transaction of fees, there is very little NPH in there for the quarter. So it was primarily driven by our core business and just highlighting the $6 million of conference fees in the prior quarter, so that $5 million of increase, I'd say, is just a mix of activity as well as the little seasonality on the IRA side. I think when you think about our P&L line items, I mean this line item particularly was driven more by the number of advisers that we have and activity levels in the market as opposed to others that are probably driven more by the size of the AUM. So I'd use that as your focus to estimate going forward.

Conor Burke Fitzgerald - *Goldman Sachs Group Inc., Research Division - VP*

I'm sorry, that's great color. But I was just looking for the other asset-based fees. Sorry.

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

I?m sorry, I thought you said non-asset-based fees. So other asset-based fees, sorry, so about half of that was NPH, about half was core. And it was both revenue share and record keeping, driving up. So I think the 2 drivers there are going to be on the revenue share side, primarily driven by the brokerage assets, and the record keeping side, primarily driven by the advisory assets. So if you look at our net new assets and growth in those 2 areas that probably gives you a sense as to where those 2 items are going.

Operator

Our next question comes from Steven Chubak with Nomura Instinet.

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

So Matt, I appreciate the color you've given in response to one of the earlier questions on capital management priorities. And certainly the step up in share repurchase was nice to see. You noted that. You view your share price as attractive, but in the context of your leverage ratio at sub 3x, and taking into consideration the improved EBITDA from NPH, the tax windfall, it still appears to be pretty modest to us. I'm just wondering is the 3.25x to 3.5x still the go-forward leverage target? And assuming that target still holds, do you have any appetite to actually accelerate share repurchase in light of some of those tailwinds as well as your capacity?

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

Yes. So Steven, the target is unchanged. I mean, I think, and our overall approach hasn't changed as we covered a bit. When you look at our opportunities for organic growth, M&A which you need to be prepared for and may or may not come. And definitely, returning capital to shareholders. I think we see those as great opportunities to drive value. And on the organic growth side, just to make sure we don't miss our views and point there. Our focus in 2018 is doing deploying more capital for recruiting and transition assistance. Dan talked about how from a technology standpoint, we are now investing over $100 million a year in technology to drive capabilities. We still have got the cash associated with wave 2 for NPH. There is a lot of things that we are focused on. I think when you look at our leverage target, we definitely have a lot of capacity. When we talked at Investor Day, the $1.2 billion to $1.8 billion range, when we sit here today as I think you were directly highlighting that, that capacity is higher. And that's true. I think we like the position we're in, right. We've got more liquidity and lower leverage because our earnings have grown so much, and that gives us a lot of flexibility to be patient and focused on the best place to deploy it. So I think we're focused on it, and hopefully, we gave you a fair bit of color on how we think about where it should go.

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

And just one follow-up for me. You've certainly done a great job of maintaining strong discipline on the expense side and I appreciated all the color that you have given on the core G&A outlook. I'm just wondering to what does extent the expense leverage that you highlighted, is that contingent or does it contemplate higher rates as well as market tailwinds? Or are you committed to delivering that even absent any upside from higher rates in markets?

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

Yes, I think our commitment and focus is on delivering operating leverage, right. Now let's -- there are extremes where that will be challenging for any business model anywhere, right. So depending on where you would shock the macro and where interest rates would go. But I think in the reasonable scenario range, I think, we are focused on delivering operating leverage. I think we have demonstrated that and that would be where our focus is.

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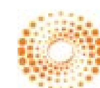

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Operator

Our next question comes from Craig Siegenthaler with Cr?dit Suisse.

Craig William Siegenthaler - *Cr?dit Suisse AG, Research Division - Global Research Product Head for the Asset Management Industry*

So I just wanted to come back to your comments earlier on the SEC's potential fiduciary standard rule. Can you help us think about what incremental investments and product tweaks we could see, if any, if the SEC releases its own rule? And I'm especially thinking about taxable accounts here.

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

Yes. So this is Dan. I'll -- let me take that one. And I think look, first of all, we, as you know, we believe in a higher standard of care, and we actually believe that we will have a rule in the short run. I think with the SEC, as it contemplates the potential rule, we actually see an opportunity that, that rule would apply across both qualified and nonqualified accounts, which we think is a really good thing at the end of the day because you create consistency across all accounts. With the anticipation that, that was sort of the best approach, most of the changes that we've made up to this point or all of the changes that we've made up to this point apply to both qualified and nonqualified accounts. So even if the SEC comes out with something, that is not a big pivot for us based on how we've approached it. And I think as you know, we invested heavily on the front end to make sure that we are prepared. Just like what we said at Investor Day, we've done 90% of the work relative to preparing for the overall DOL rule. We think what the SEC, to the extent they come out with a rule, we think that the work that we've done well positioned us for that, and we don't think there is a big pivot or adjustment relative to our overall financial outlook even if the SEC comes out with a rule. Does that answer your question?

Craig William Siegenthaler - *Cr?dit Suisse AG, Research Division - Global Research Product Head for the Asset Management Industry*

Yes, that's good. And just I have a follow-up here. I think I heard earlier in the prepared remarks that you guys have plans to increase the investment spend, while also driving operating leverage, and I thought that was more of a longer-term comment. And if I'm right, could you mind just digging a deeper in the investment spend side and let us know what type of increase or pick up we could see, and also where the investments are focused here?

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

Why I don't share with you where we are focused on those investments? And then Matt wanted to add on any color on sort of how that shows up from a financial standpoint. So as we think about the allocation of that capital to key areas, right, you gotta remember one of our key strategic initiatives is driving core growth and so that would be the place that we would tend to prioritize that, as Matt said. And so we think about driving that organic growth across 3 lens. How do we drive assets with the new store sales or attracting new advisers? How do we grow assets in support of our existing advisers? We'll refer to those as same-store sales. And then finally, how do we improve or enhance the return on those overall assets? So I'll give you a little color on how we think about that investment spectrum across those 3 lens. So the first one on new store sales, we would tend to allocate investment and this would show up both as technology, mainly technology investment, and that would show up in places as an example, where we might improve and enhance our overall processes, techniques and approach to selling and recruiting. You've always looked and say how can you iterate and do better with your market opportunity or as things evolve and change. And so that's us looking at ourselves and investing in our core sales capabilities. Second place would be continuing to improve our technology platform or our advisory and brokerage platforms, creating differentiators that help us use those differentiators to attract more advisers. And the third one would, obviously, be continuing to deploy our financial assistance or transition assistance in that overall recruiting effort. I think on same-store sales or that second lens, that shows up in things like, again, continuing to expand our advisory and brokerage platforms through new workflows, new investment content, lower prices that help our advisers position themselves to differentiate and win and attract new assets. That would be delivering a new digital experience to our advisers clients. And then finally, that would be the delivery of our virtual services that I referred to earlier, which are additional new services that help our advisers outsource more administrative work to us that help in their overall execution of practices. That maybe a way to think about the same-store sales. And then finally, on the ROA front, again, that would be continuing to invest in our corporate advisory platforms, in our centrally managed platforms. Things that are going to attract more assets to places where we create more value, and ultimately, that mix of business

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drives a better return on those assets. So those are just some of the examples, I think, of how we think about where we would deploy some of that capital or some of that investment. Hopefully, that answers your question and Matt, I'll turn over it to you to translate that to financial implication.

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

Yes. You covered it well, Dan. I think the -- when you look at the delivering operating leverage on the other side of that, I mean, the majority of the expenses and things that Dan was talking through are the investments and transition assistance that we talked about and the technology, which we put a number around a north of $100 million. Those -- that technology costs are mostly going to show up ultimately in core G&A and depreciation over time. But I think that's probably the most color we can give you. When we look at our view on where our revenues, our gross profit is going and in the investments that we plan to make along that path, we see delivering operating leverage, while doing all the things that Dan described.

Operator

Our next question comes from Ann Dai with KBW.

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

First thing, I was wondering about was, you guys talk about this EBITDA production equivalent of 80%, obviously, same as your last guidance. The production transfer of 70% and then the asset transfer range of 65% to 70%, which I think is new. So can you just bridge the gap for us between those numbers and highlight the drivers of those deltas compared to your original assumptions coming in?

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

Yes, sure. I'll give a little color. I think when you grounded in the production transfer, I mean, and even starting with advisers, when we think about 2,000 of the 3,200 coming over, we are getting about 62%. And I think getting 62% of the advisers and 70% of the production just speaks to the level of -- and quality and production of the advisers coming over versus those that have chosen to go elsewhere. I think you take that same concept into the assets, right, at 65% to 70%, we are getting the higher returning assets. So there are more producing assets, and then taking that further into EBITDA combining with where those assets are going on our platforms. The profitability associated with that mix, and ultimately, the cost that we need to badge against that. And you get even more productive in that, and you get to the 80% equivalent. So I think that's just -- at a high level, it's just that the quality and mix of the advisers that have chosen to come over as well as the mix of assets and where those are going on our platform.

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

Okay. And I know you might have covered this a little bit in your remarks and earlier question, but if we think about the -- you mentioned $5 million of run rate costs this quarter within core G&A. So is that something we can kind of extrapolate and take it and run or how do we think about that into the early parts of '18?

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

Yes, with respect to NPH, I think, the best way to think about is just the guidance for 2018 overall. So for NPH, $70 million, $80 million. And then looking at Q1, just being biased to be one of the higher quarters, if not the highest quarter, of the year. Just given the amount of onboarding that's going to come on in that quarter, so that's the -- probably the best way to think about it.

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

Okay. And just based on the onboarding number from fourth quarter that was within core G&A, and then the total $20 million of onboarding up to this point, if we just run rate that, that would suggest something in the lower end of your $40 million to $60 million range. And I guess, I'm just wondering if there is anything esoteric we should be thinking about in how those expenses might look in the first quarter and '18? And I recognize that they probably -- mostly in first quarter.

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

Yes. So I think, if you take a look at the key metrics deck or supplement that we put out, on Slide 19, we've got a little bit of context on that exact topic. On our $40 million to $60 million, that estimate in that range is unchanged and it gives you a sense of the $20 million that we've had so far, and the $20 million to $40 million that would come in 2018. So I would just focus on that. We get a little bit of context on the financial assistance side as well that shows up in promotional to give you a sense as to how we see '17 versus '18. So hopefully, that will be helpful.

Operator

Our next question comes from Doug Mewhirter with SunTrust.

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

First question, more of a general question, it sort of reflects just the environment that's going on right now. I know the typical LPL client is not a trader per se, it's more of a trying to manage his financial life. But have you noticed a recent, as in the last 2 months, uptick in transaction activity or transaction revenues? We've seen that really big surge amongst the self-directed online brokers. And I don't know if any of that is transferred over to that -- to your clients' behavior.

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

Yes, this is Dan. Let me try to help you with that. I think there is a distinction between the client in the other firms that you referenced in that model versus the one that we have. Ours is much more oriented around creating a financial plan and helping that client executed over a longer period of time. And so you're not going to have as much volatility in your trading activity relative to certain market conditions or changes as you might in the other models. So I don't believe you see that transitioning over into our kind of full service or wealth management model. I do think as you think about though advisers and market movements and try to -- how they help position or reposition portfolios, when you do have volatility in the marketplace, you will see advisers go in and try to help clients reposition those portfolios. So you will see additional trading activity, but it's occurring for, I'll call it a different reason or a different context perhaps -- then perhaps that discount trader and their trading activity. I hope that helps give you color.

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

Yes, that is helpful and that's what I suspected. Just wanted to confirm. My last question, on the broker protocol, you mentioned that you are committed to it from LPL's standpoint. Have you -- have the nature or the timing or the amount of transition conversations changed because a large number of your potential sources of new talent have gone out of the broker protocol, has made it more difficult or is it actually spurring people trying to jump ahead of it or just how has that changed the nature of your recruiting effort recently?

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

Yes. Certainly, I think, there is always the pause to -- and people purposely trying to understand what does this change mean, right. And so, I think, there is the expected conversation that would occur around kind of the change assessment. That said, I think when you get back to the dialogue

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around the business itself, we haven't seen a lot of the dialogue change. Now maybe some of that it's because the firms that have opted out of the protocol thus far, make up a much smaller percentage of our overall recruiting portfolio, right. It's on the order of magnitude of 10%. And then secondly, we've continued throughout the years to recruit from both protocol firms and nonprotocol firms. So we understand that process on both sides of that, and so though these firms have opted out of the protocol, you just sort of flip them over to the process that you might use on the other side of that line, and it becomes more of a business as usual conversation. So hopefully, that helps you.

Operator

Our next question comes from Chris Harris with Wells Fargo.

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

It sounds like the investments you guys are making are really designed to accelerate the organic growth. So how should we be thinking about, like, the reasonable base case, if you guys really execute on those investments, should we be thinking, like, the growth can go up to like a 5% range again or how should we think about that?

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

Yes. So Chris, this is Dan. I think -- yes, and it's one of our priorities and we continue to invest resources to grow that. We actually look at that from the standpoint of gross profit growth, which is driven, again, by assets and return on those assets. And we have an aspiration to continue to increase and grow that number. We're focused on the activities that drive the results and unnecessarily focused on predicting what that outcome would be, but continue to work on it to drive returns on that investment and effort we're making.

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

Okay. The other question I had was on your base payout rate, it tick down from the third quarter. How should we be thinking about that in 2018? Could it go up a little bit as we onboard more of the NPH advisers? Any guidance there would be helpful.

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

Yes, Chris. I wouldn't -- when you look at the change, even over the last couple of quarters or this quarter, down 45 basis points. It's within the normal range of mix movement. I think when you go back prior to some of the pricing changes we made, there was a more of a difference between the payout where mix between brokerage and advisory could drive some more volatility in driving that payout rate down. That margin is much smaller now. So really the mix noise should be relatively minor. So we don't see any meaningfulness other than normal quarterly movements.

Operator

Our next question comes from Devin Ryan with JMP Securities.

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

And maybe a follow-on to an earlier question. Trying to drill down a little bit more into the -- essentially to hit the $85 million of EBITDA, are you still targeting the 300 incremental employees and the same infrastructure? Or can some of that expense flex with adviser production? Really what I'm just trying to get out here is maybe a little better sense of how much of hitting the 80% EBITDA equivalent is a function of stronger revenues versus maybe more expense leverage than initially outlined?

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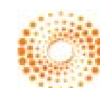

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Matthew J. Audette - *LPL Financial Holdings Inc. - CFO and MD*

Yes, Devin, it's a little bit of both. I'd say it's primarily on the revenue side. I think on the headcount side, where our estimate was 350 folks, we've hired 200 so far. I'd say probably ahead just under 350, call it 330, 340 is the current plan. So the little bit of expense benefit as you would guess, but I think it's primarily the -- on the revenue side and the mix.

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

Got it. Okay, helpful. And then just a follow-up here. Just a question about the advisory business. It looks like hybrid assets grew faster than corporate in the quarter, but you made the fee cut to start the year. So I'm curious if you're seeing any change in behavior, as a result of that. And then just -- additionally, with the press reporting that FINRA is thinking about maybe ending hybrid oversight, just curious how that might change the value proposition of hybrid rather than the corporate in any way. If it does, it's just rather considerations there would be from that, since you guys have the biggest footprint there?

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

Yes, good question. Devin, this is Dan. Let me take that. And so obviously, we've positioned both our hybrid and our corporate models to be very competitive and we think offering those diversity of models help us reach a broader appeal, sorry, a greater appeal to a broader number of advisers. And so that is absolutely our strategy. And there's been a growing demand in the corporate RIA because the regulatory environment gets tougher and that value that we provide from a risk management standpoint continues to increase in its appeal, and so we've invested last year in both in the corporate RIA and both capabilities as well as lowering price. And I think we got the expected response from that, which was very favorable relative to both existing clients as well as prospective clients. I think it's early on because remember, we didn't actually implement the change until November. So it would be early to call data points or say, I have data points that reinforce that other than just the initial reaction and dialogue we've been having with clients. But again, based on that dialogue, we feel that we are on the right course and right trajectory with that. I think at the same time, we've got to continue to ensure that our hybrid program is competitive and we will continue to invest in that hybrid program. And I think with respect to then -- as you pull all the way through to your question about if FINRA, ultimately changes the oversight of those hybrid programs. I think, having the competitive capabilities of both is obviously an advantage because I think you can think through a continuing environment where both can have certain appeal depending on the needs of that adviser. Not knowing the exact rule change, I can't speak specifically to it, and there will, of course, be a comment period and a process around that of which obviously we would have lots of thoughts and point of view and be a big contributor to that overall process. So it's hard to be specific, but we do think this diversity of the models will help us in an environment should FINRA change its oversight.

Operator

Our next question comes from Chris Shutler with William Blair.

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

Just one real quick one. The forgivable loans that you've been providing, can you just walk through the or talk through the average length of those for the NPH advisers, I know you said 3 to 5 years before, but you are trending kind of low-end, high end of that?

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

Sure, Chris. I'd say probably close to the low-end or the shorter end, so closer to 3 than 5.

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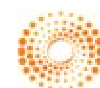

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Operator

Our next question comes from Michael Cyprys with Morgan Stanley.

Zachary Noah Feierstein - *Morgan Stanley, Research Division - Research Associate*

This is Zac Feierstein filling in for Mike. Just a quick one, first. Is the make up of the wave 2 advisers similar to those who came over in wave 1?

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

Yes. So Zac, this is Dan. Yes, I think, that's a fair characterization. Remember, there is a larger number of institutions in wave 2. So that modifies the makeup a little bit, but I think, it's directionally fair to say it's a similar type of profile where the approach that we took was consistent both with one -- wave 1 and wave 2, where we stayed disciplined around our financial and risk standards, and we tended to create and attract those advisers that's all appeal to a broader breadth of our services and that would ultimately leverage those capabilities more broadly like our advisory platform. So I think, it's fair to characterize them similar, with the one caveat being that, there will be a larger number that are in institutions.

Zachary Noah Feierstein - *Morgan Stanley, Research Division - Research Associate*

Great. Getting back to adviser recruiting, you mentioned in your prepared remarks you brought on 98 net new advisers ex NPH this year. Are there any areas of incremental spend on maybe the promotional side or other initiative you can take that could help drive this organic growth in the future?

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

Yes. Look, I think, when you think about recruiting, we actually look at other measures as a way to reflect and understand the strength of our recruiting and that would be the assets that we're bringing it from recruiting. So in terms of when you look at our net new adviser number, there is -- that's influenced by both adviser that are coming in and going. And I think we landed at around $25 billion in recruited assets last year and we look at that and say that's a pretty solid year. Do we work to enhance and increase that? Absolutely, yes. And again, as I said earlier, we continue to look at investing in new automation and technology that makes it easier to, for an adviser, to move from another firm to us, So take more of the friction out of that process, and that can generate some positive returns, and obviously, help your recruiting overall volume. We'll continue to use transition assistance, and I think we continue to explore how to use that in a really targeted, creative way to attract the type of advisers that we think match best with our platforms. So we continue to explore how we best use that to attract the advisers and then again, investing in our people and our capabilities to improve our overall sales capabilities. So those are the things as we go into '19, we look to say, "Hey, can we improve upon the results in '17?"

Operator

Ladies and gentlemen, thank you for participating in today's question-and-answer session. I would now like to turn the call back over to management for any closing remarks.

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

Yes. Thanks, operator. And again, I just wanted to take a moment and thank everyone for taking the time to join us this afternoon. And we look forward to speaking with you again next quarter. Thanks a lot.

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Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect, and have a wonderful day.

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