

**“When you hear the word EBITDA,
you should substitute the word bullsh*t.”**

- Charlie Munger

Upslope is short Focus Financial (FOCS, or the “Company”) – a \$3.7 billion (enterprise value) levered roll-up of independent registered investment advisors (RIAs) that has surprisingly flown under the radar since its 2018 IPO. A quick summary of our thesis is provided below and followed by details for each item:

1. **Aggressively Pitched by Management as Something it's Not**
2. **Dubious Capital Allocation Record**
3. **Creative Earnings Adjustments and Cash Flow Metrics**
4. **Over-Levered Balance Sheet**
5. **Reflexivity Squared – Dependence on Robust Financial Markets...and Reputation**
6. **Questionable Management Incentives and Ownership**
7. **Related Party Fun**
8. **Shareholder Base Headwinds and Questions**
9. **Full Valuation, Modest Short Interest, and Significant Downside**
10. **Catalysts...or Why Now?**

1. Aggressively Pitched by Management as Something it's Not

We're often attracted to shorts where we can easily observe management aggressively pushing an investment case that doesn't sync with reality. In our [Q2 2019 letter](#), we discussed Ranpack (PACK), where management pitched the crumpled paper packaging company (our description) as a play on e-commerce, the Internet of Things, and millennial household formation (among other hot trends). We have followed the Focus story for a number of years and believe that Focus management's pitch and promotion of narratives is just as egregious:

- **“Not AUM-driven” – attempted to avoid disclosing partner firm AUM (assets under management) in S-1.** Per an Autonomous research report, “management...does not characterize its business as AUM driven, and only until the second amendment of the S-1 did it provide an estimate of the AUM managed by its partner firms.” This seems bizarre and a blatant red flag, given the nature of the business (wealth management with asset-based fees – even FOCS now admits 73% of revenues are “market-related”¹).
- **Management-defined "organic" growth includes partner² acquisitions and market appreciation; refuses to disclose true underlying organic growth.** This has been an ongoing issue since FOCS filed to go public, with pushback from both the buy- and sell-side. We believe it is preposterous that a levered roll-up with a market-linked business (i.e. revenues driven in part by equity market prices) not disclose detailed information on true organic growth. FOCS' COO made some light of the issue at the 2019 investor day (emphasis Upslope's):

¹ Q3 2019 earnings presentation.

² For clarity: we view this as similar to a company including acquisitions made by subsidiaries in its organic growth figures.

*“Let me ask the question, it's probably going through a lot of your minds right now. **Why does Focus insist on calling mergers organic growth?** Because mergers are the most efficient way to accelerate client acquisition and talent acquisition. I live in New Jersey, come to Manhattan. I could have taken a scenic route. I could have taken local, like Route 9. I chose to take New Jersey [Turnpike]. All roads lead to Manhattan. Some are faster than others. My route was faster. All avenues lead to organic growth. Mergers happen to be. And in this industry, in this environment, with the opportunity that is available, and Lenny's going to talk more about it, if you have access to M&A expertise, if you have access to capital and you know how to do good accretive mergers, it is the fastest way. Mergers are the most efficient way to accelerate client acquisition and talent acquisition.”³*

“I’ll take tortured excuses for not disclosing basic information for \$500, Alex.” We find it curious management has gone to such lengths to avoid disclosure, which would obviously enhance investors’ ability to assess the underlying health of the business. Even if there are arguments in favor of valuing acquisition growth on par with organic, why not provide the information and let the market decide?

- **Management claims its model results in an “annuity stream”⁴ – we believe that in reality Focus’ RIA partners will experience distress (or walk) in a serious downturn.** Management claims its deal structures provide downside protection, with the 'annuity' comment effectively suggesting (again) that FOCS isn't tied to equity market performance. We think this fails a common-sense test and that the model is simply optimized for bull market conditions. An illustration of the structure is provided below:

Exhibit 1: Earnings Split Example

	Revenues in-line with plan	Revenues 10% above plan	Revenues (10)% below plan
<u>Entire economics</u>			
New partner firm revenues	5,000	5,500	4,500
Less: operating expenses (ex. mgmt fees)	-2,000	-2,000	-2,000
Earnings before partner comp (EBPC)	3,000	3,500	2,500
Base earnings to Focus (60%)	1,800	1,800	1,800
Mgmt fees to mgmt company (40%)	1,200	1,400	700
EBPC in excess of Target Earnings:			
To Focus (60%)	-	300	-
To mgmt company	-	200	-
<u>Focus reported financials</u>			
Total revenue	5,000	5,500	4,500
Operating expenses	-2,000	-2,000	-2,000
Mgmt fees to mgmt company	-1,200	-1,400	-700
EBIT	1,800	2,100	1,800

Source: Autonomous, Upslope (annotations), Company filings

The above structure is certainly attractive for FOCS in managing through *ordinary, short-term corrections* during a bull market (e.g Q4 2018, which was sharp, but impressively brief). But in an extended downturn, someone will pay the price for this stability (see red annotations above). We think

³ Transcript source: Sentieo.

⁴ CFO comments from 2019 Investor Day.

it's obvious that partners near the preference "strike price" will experience distress (or just walk) in a more serious market downturn – hardly an "annuity stream."

2. Dubious Capital Allocation Record

From 2013 to 2019 Q3 (YTD/LTM figures used as appropriate), a period during which the S&P 500 more than doubled, Focus did the following:

- Spent \$1.6bn in cash on acquisitions
- Generated an incremental \$94mm in annual cash flow from operations
- Saw cash flow from operations as a % of adjusted EBITDA fall from 99% to 62%

Management notes, "we typically pay mid- to high single-digit multiples" (CEO, Q2 2019 earnings call). Let's assume FOCS paid 8x in aggregate for its \$1.6bn in acquisition spend since 2013. Simplistically, this would imply incremental earnings (or ideally cash flow) of ~\$200mm – more than double actual incremental cash flows just from acquisitions alone.

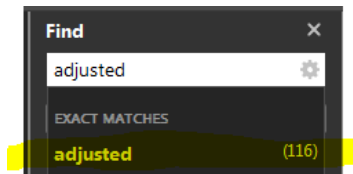
Management also claims, "the number of firms that joined us that ultimately doubled, tripled, quadrupled or more in size after they joined us is, even for us, pretty stunning" (CEO, December 2018 GS Conference).

Combine the above comments with math and the fact that from 2013 - Q3 2019, the S&P 500 was +108% and it becomes awfully hard to reconcile management's commentary with results to date (incremental operating cash flows of just \$94mm despite \$1.6bn of acquisition spend at mid-to-high single-digit multiples, and multi-bagger "organic" growth at a significant⁵ number of partner firms). What's going on here? We can only speculate, but in our view, the two most likely possibilities are: (A) management is paying significantly more than stated for acquisitions, and/or (B) as FOCS partners join the platform, they're not "creating enduring value well into the future," (another CEO line from the Q2 2019 call) but deteriorating under FOCS' purview.

Bottom-line: if the Focus model isn't *obviously successful* during a raging bull market with cheap financing for massive acquisition spend, what happens to the business in a downturn?

3. Creative Earnings Adjustments and Cash Flow Metrics

Please just look at this before proceeding:



One hundred and sixteen times. That is how many times the word "adjusted" appears in Focus' 2019 investor day deck. As one might expect, the list of adjustments that management "recommends" is long and it includes quite a few clearly-recurring items,⁶ as well as equity-based comp (very unusual for Focus' peer group).

⁵ We assume he's suggesting this is the case at a significant number of partner firms. Why make the comment if it's immaterial?

⁶ A few examples of adjustments we take issue with: amortization of debt financing costs and intangible amortization (both clearly recurring, given the nature of the business and...the historical record), other one-time transaction expenses (includes expenses related to FOCS' IPO and reorg. transactions – fine with us. But, it also includes expenses from an acquisition – definitely not fine, given M&A is core to the FOCS model).

Exhibit 2: “Impressive” List of Earnings Adjustments

	Full Year					
	2013	2014	2015	2016	2017	2018
<i>(\$ in thousands, except share and per share data)</i>						
Net income (loss)	\$ 8,677	\$ 11,996	\$ 9,321	\$ 15,722	\$ (48,359)	\$ (41,087)
Income tax expense (benefit)	975	212	649	981	(1,501)	9,450
Amortization of debt financing costs	1,267	1,599	1,770	2,482	4,084	3,498
Intangible amortization and impairments	29,910	28,549	35,421	50,942	64,367	90,381
Non-cash equity compensation expense	3,277	4,319	13,537	8,520	34,879	44,468
Non-cash changes in fair value of estimated contingent consideration	1,239	7,395	(160)	(1,143)	22,294	6,638
Gain on sale of investment	—	—	—	—	—	(5,509)
Loss on extinguishment of borrowings	—	—	—	—	8,106	21,071
Delayed offering cost expense	—	—	—	—	9,840	—
Management contract buyout	—	1,800	—	—	—	—
Other one-time transaction expenses (1)	—	—	—	—	2,843	11,529
<i>Subtotal</i>	45,345	55,870	60,538	77,504	96,553	140,439
Pro forma tax (27%) (2)	(12,243)	(15,085)	(16,345)	(20,926)	(26,069)	(37,919)
Tax adjustments (2)(3)	5,455	5,919	8,080	11,991	16,217	22,828
Adjusted Net Income	\$ 38,557	\$ 46,704	\$ 52,273	\$ 68,569	\$ 86,701	\$ 125,348

Source: 2019 Investor Day presentation, Upslope (annotations)

Also note that Focus employs a few creative definitions of free cash flow (we pay attention when companies suggest investors look away from the obvious line items on the statement of cash flows). While management likes to conflate organic and acquisition growth, they are of course crystal clear in ensuring acquisition spend is nowhere to be seen here (adjusting out contingent consideration):

Exhibit 3: Statement of Cash Flows Isn’t Good Enough?

<i>(\$ in thousands)</i>	Trailing 4-Quarters ended	
	Sept. 30, 2018	Sept. 30, 2019
Net cash provided by operating activities	\$ 93,579	\$ 149,621
Purchase of fixed assets	(8,330)	(23,538)
Distributions for unitholders	(1,894)	(16,661)
Payments under tax receivable agreements	—	—
Adjusted Free Cash Flow	\$ 83,355	\$ 109,422
Portion of contingent consideration paid included in operating activities(1)	8,483	17,579
Cash Flow Available for Capital Allocation(2)	\$ 91,838	\$ 127,001

Source: 2019 Investor Day presentation, Upslope (annotations)

4. Over-Levered Balance Sheet

At the end of Q3, Focus was levered 4.3x net (using a heavily adjusted EBITDA), within management’s *recently-boosted* target range of 3.5-4.5x. Simply put, we think this is an irresponsible amount of debt for a financial services business whose operating performance is directly linked to financial markets.

5. Reflexivity Squared – Dependence on Robust Financial Markets...and Reputation

Focus is dependent on healthy financing markets and bull market conditions in multiple ways:

- Fundamentals linked to and driven by growth (or declines) in equity/fixed income markets – 73% of Q3 of Focus' revenues were "correlated to markets" in Q3 2019.
- Acquisition growth strategy is highly dependent on the continued availability of cheap debt financing.
- Stock-based compensation (dependent on FOCS share price) is a material expense.
- As a wealth management business, it is imperative Focus maintain a reputation as being a financially solid and trustworthy counterparty. Heavy dependence on capital markets and a high debt load appear to be a major risk on this front. That is to say it's not hard to envision a scenario in a market downturn where *clients* begin to worry about the health of the business managing their money.

6. Questionable Management Incentives and Ownership

Share ownership among the Focus management team is rather unusual for a financial services company: most own very few shares (if any) outright and have very large numbers of options. For example, per the 2018 proxy, CFO Jim Shanahan owned zero shares outright and had over 2mm options (equivalent). CEO Rudy Adolf owned less than 60k shares outright, but had nearly 5mm options. In our view this creates a misalignment of incentives – pushing management for growth-at-any-cost. We think this attitude and these incentives are reflected in FOCS' surprisingly high debt load and the aggressive narratives promoted by management.

7. Related Party Fun

What would a short thesis be without a few quirky related party issues (and a plane)? We note the following:

- The CEO owns a plane and FOCS reimburses him for using it (when used for business). This is an unusual arrangement and we think at the very least it sends a fairly poor message about management's priorities. Interestingly, the CEO's 2017 employment contract set a cap on reimbursement at \$800k. Of course, the board of directors (as is its right) approved a \$1.7mm reimbursement for 2018.
- The CEO's ~27-year old son works for Focus in a well-paid business development role, despite a seeming lack of prior relevant (any?) outside experience.

8. Shareholder Base Headwinds and Questions

Some interesting observations on the shareholder base – both past and present:

- Private equity firms still own almost half of FOCS shares – not a red flag on its own, but this should certainly be an overhang on shares for years to come.
- Highly respected shareholder, Akre Capital Mgmt., quickly headed for the door. Based on public filings, Akre established a position in 2018 (around the IPO) and exited <1 year later.

9. Full Valuation, Modest Short Interest, and Significant Downside

FOCS trades for 12x (heavily adjusted) 2020 EBITDA and has just 3%/7% of equity/float short. Given the elevated risks outlined herein – heavy dependence on bull market conditions, aggressive leverage, poor disclosure, questionable management alignment with shareholders – this all seems quite generous. While there are no perfect “comps,” LPL Financial (LPLA – a well-run broker-dealer exposed to similar end-market trends) trades for <9x EBITDA.⁷

Based on the above, we think FOCS shares are worth no more than \$20 (33% downside) – assuming continued, favorable bull market conditions for the business. At \$20, shares would trade closer to 10x (heavily adj. EBITDA). **In a more serious market correction, we see at least 50% downside** to shares, assuming FOCS valuation approaches that of the more troubled asset manager stocks (i.e. well into single digit EBITDA multiples) – as a result of an aggressive leverage profile and operational dependence on financial markets.

10. Catalysts...or Why Now?

We see two potential catalysts for a Focus short. First, longer term, we think a market downturn will severely hurt the operating performance of and equity in the business – *especially* in light of the over-levered capital structure and questionable “downside-protection” model.

Second, and a bit more timely, per Focus’ Q3 2019 10-Q, “Focus...is subject on an annual basis to contingent principal payments based on excess cash flow for any fiscal year if the First Lien Leverage Ratio exceeds 3.75:1.00.” This ratio stood at 4.27x at Q3 2019 (following a smooth up-trend from Q4 2018’s 3.3x). While we don’t know how Focus finished out 2019, the Company seems uncomfortably close to the 3.75x level (even if we apply current net debt to 2020 consensus EBITDA, leverage is still 4.0x). **It would not surprise us to see Focus try to raise equity** in the relatively near-term (a welcome catalyst for shorts – especially with shares trading below its \$33 IPO price). Either way, if Focus finds itself subject to this restriction, executing its acquisition playbook is likely to become quite difficult.

As Focus CEO Rudy Adolf so aptly put it in August 2019, “if you don’t grow, you die.”

Key Risks to the Short

- Growth model could stay afloat longer than expected.
- Organic growth could eventually be disclosed as better than expected.
- Sale to a strategic buyer.

⁷ As of January 14, 2020. Source: Sentieo.

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