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Is BlackRock's margin sustainable?

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One of the items from the third quarter earnings season that got my attention was comments made by BlackRock Inc. executives about the company's operating margin, which was 43% in the third quarter, according to S&P Global Market Intelligence (management cited 45% on an adjusted basis).

Both CFO Gary Shedlin and CEO Larry Fink stated that the company is not managed to a margin, but management is "margin aware." I am paraphrasing by putting words in their mouth, but my take is build-it (correctly) and they will come. As an industry observer and not an insider I raise the question: Is the margin sustainable for Blackrock and the asset management industry more broadly?

Growth versus margin depends on one’s perspective. On Wall Street equity investors usually will favor growth over margin, provided margin compression does not overtake growth and produce lower earnings. Profitable growth produces capital appreciation. The exception may be short-term trade-offs of lesser earnings today for much higher earnings later. Debt investors generically prefer margin over growth to ensure sufficient cash flow to cover debt service.

My musing about the seemingly high margin is because the financial services industry has experienced a multi-decade pricing deflation that has been offset by volume growth in most areas. On May 1, 1975, the SEC abolished fixed-rate commissions to trade stocks. The event was referred to as "May Day." Brokerage firms were forced to embrace capitalism and negotiate prices. I assume there were plenty of doom-and-gloom arguments then that Wall Street would suffer, but embarrassing riches followed in the ensuing decades. Trading volumes rose as lower prices to transact attracted more capital. Technological advances furthered the cause.

Although the Charles Schwab Corp. was founded before May Day, it as much as any firm has prospered from falling commission and rising volumes. Of course, Schwab has morphed into something much beyond a humble discount brokerage firm. In its most recent quarter net interest income exceeded $1.0 billion thanks to its banking operations, while asset management and administration accounted for $845 million of revenues. Trading-related revenues yielded only $157 million, which is a testament to the profitability of asset gathering over asset transacting.

Elsewhere in the financial services industry the pricing model is under intense pressure. Hedge funds are cutting fees to stem a tide of fleeing assets. A number of business development companies have cut fees paid to external managers, too, in an effort to offset poor performance and/or keep proxy proposals to shift management contracts elsewhere from succeeding. The institutional fixed income and equity businesses (sales, trading and research) are under tremendous and well-chronicled pressure. The asset management business does not have a moat to protect it from the secular forces of faster-better-cheaper that have enveloped every industry other than healthcare and education as far as I can tell.

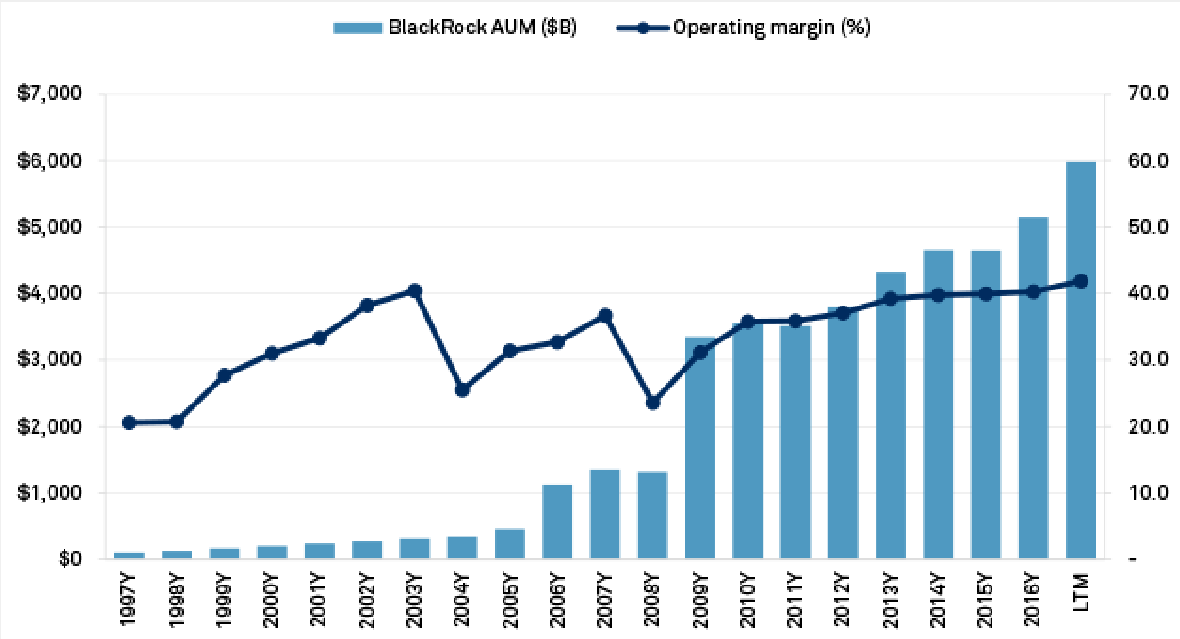
As indexing proponents John Bogle and Charles Ellis more or less predicted many years ago the model of charging investors upwards of 1.0% of assets on an annual basis to manage assets is fading as the shift of funds into ETFs and index mutual funds becomes a torrent. Many active managers have responded by cutting fees. With that as a backdrop, am I off-base to question the sustainability of Blackrock's margin?

Blackrock and other behemoths have the advantage of economies of scale that have positioned these firms to be price leaders just as Schwab has been among online brokers. Nonetheless, volume will not necessarily grow forever. And what happens if an extended bear market develops—especially if it is a bear market in which both bond and equity prices fall? I doubt the cost structures are very flexible absent a blunt ax even over an intermediate time frame to offset what could be a substantially lower revenue run-rate.

In raising the margin issue in no way am I knocking what Fink and his co-founders have achieved. Blackrock, which was founded in

1988 by a cadre of fixed income types and today has nearly $6 trillion of assets under management, is a stunning American success story. The AUM history in the accompanying graph is amazing, helped in part by the very well-timed acquisition of Barclays Global Investors in mid-2009 that included iShares. Fink has been an extreme value creator for shareholders. The shares have produced a total return of 3695% (i.e. ~37x) since year-end 1999 through November 3. Pick the index — the S&P 500, SNL U.S. Asset Manager, Russell 2000 — Blackrock's shares have vastly outperformed over this period.

BlackRock: Is it sustainable?



Last-12-months as of Sept. 30, 2017.
Source: S&P Global Market Intelligence

But, trees do not grow to the sky. It is impossible to know everything that is priced into a stock other than perhaps at extremes when deep pessimism and euphoria reign. With the shares trading for 22x earnings, I do not think many will argue the valuation reflects euphoria, particularly given the run in equity markets that has seen multiples expand for many companies in recent years. Perhaps Blackrock is the ultimate proxy for the market given the advance in its shares and expansion in its P/E from less than 15x five years ago. Nonetheless, like so many other assets, the shares may not offer much valuation cushion if the margin begins to trend lower without sufficient growth to offset.

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