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Technology Analysis for Business & Investment

Financial Engines **(NASDAQ: FNGN - \$16.71)**

Retirement Investing for the Masses

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Financial Engines provides automated and semi-automated investment advice mainly for retirement plan (401K) investing. The company has relationships with plan sponsors (big companies) who offer retirement investing products to employees as a benefit as well as investment product providers like Vanguard and T. Rowe Price.

The company uses a set of proprietary algorithms and models to give investors a tailored portfolio that they can implement directly themselves. In addition, the company provides a portfolio management service that includes discretionary managed accounts along with investment advice and retirement planning. By using their models to match investor wants and needs with the myriad available investment options, Financial Engines can provide a simpler, more automated and higher quality process for individual investment decision making.

The company has been building its business for over 10 years and has been well-funded with \$166M in capital from leading venture firms (NEA and Oak Hill) and strategic investors. The recent IPO priced above the range at \$12/share on March 15th and has traded in the \$16-17 range since then.

Our Intrinsic Value (IV) estimate of \$18 points to additional upside this year. The long-term nature of the business opportunity and recurring revenue model may also allow some investors to look even beyond the five year horizon we use in our IV process.

The company reports their first quarter as a public company on May 11th.

INTRODUCTION

Financial Engines, Inc. is an online investment advisory firm focusing on providing financial retirement solutions for employees covered under 401K. It was founded in 1996 by Nobel Laureate Dr. William F. Sharpe who was, and continues to be, a thought leader in financial economics. Financial Engines makes its money solely through its advisory services, meaning that they can be termed "independent", unlike most investment advisory organizations which also make money via commissions from financial instruments — stocks, insurance, mutual funds etc. — which they sell. Financial Engines deploys its proprietary mathematical algorithms to formulate investment related advice.

Financial Engines sells its online advisory services to its principal segment — employees covered under 401(K) through their employers — as well as directly to the individuals. Per recent figures, Financial Engines has over 750 large employers as its customers, who stand to gain from their ability to provide their employees highly customized retirement plans. Financial Engines works with leading 401(k) providers like ING, Hewitt and JP Morgan to provide these institutions the ability to offer uniquely customized retirement solutions based on individual employee needs.

For the year 2009, Financial Engines had sales of \$85 million with an earning of \$5.7 million, which is a huge turn-around for a company that had been posting losses since 2006 (the company sales for 2008 were \$71.3 million with a loss of \$3.6 million).

Financial Engines went public on March 15th when their offering was priced at \$12; just above the \$9-11 filing range. The shares have traded up and settled into a \$16-17 trading range.

This report delves into Financial Engines, Inc. as a company and an investment by examining the market, the product, company positioning, and the opportunities and threats that it faces. We also provide a valuation discussion.

MARKET OPPORTUNITY

The company operates in a vast and growing market of asset and investment management services. More particularly, Financial Engines has focused on the retirement saving and investment segment. A critical component of an average employee's post-retirement planning is the 401(k) retirement savings plan, which allows a worker to save for retirement and have the savings invested, while deferring current income taxes on the saved money and earnings until withdrawal. The employee elects to have a portion of his or her wages paid directly into his or her 401(k) account. Section 401(k) went into effect in 1980, and has been steadily growing. In the mid-1980s there were fewer than 8 million participants with less than \$100 billion of assets in 401(k) plans. By 2006, there were 70 million participants with more than \$3 trillion of assets in 401(k) plans.

There is plenty of market opportunity for Financial Engines in both their already penetrated customers (116 of the Fortune 500 companies and eight of the Fortune 20) and new customers. Looking just at the potential for Assets Under Management (AUM), the company has \$25.7B in AUM, which is just 1.7% of the \$1.5T in sponsored retirement plan assets.

The company can be impacted by changes in rules and regulations regarding retirement plans as well as market fluctuations, but it's clear that their ability to grow will be governed more by their ability to execute than market factors.

SUMMARY COMPANY INFORMATION

Financial Engines was formed to provide investment related advice to the millions of employees in USA covered under 401(k) who seek better post retirement life, irrespective of their earnings and net worth. It launched its first online advisory service in 1998. Financial Engines deploys its proprietary mathematical algorithms to formulate investment related advice. Headquartered in Palo Alto, CA, with 264 employees, the company has an operations and call center located in Phoenix, Arizona and some space in Boston, Massachusetts.

Financial Engines' services provide specific, actionable investment recommendations based on the outcomes an investor wants to achieve and can be delivered through the web/email, phone, or face-to-face. The company targets its solutions to the large and mid-sized organizations offering 401(k) benefits to its employees who would like to better their prospects as an employee-friendly organization. The company also targets individuals (retail), and partners with 401(k) solution "providers" (ING, JP Morgan etc) who gain by bettering their offering through customized investment advice.

The company has over 750 corporate/organizations (called "sponsors") out of which 116 belong to the Fortune 500 list. Apart from corporate customers, it has relationships with 15 "401 (k) plan providers". Through these and its direct retail customers, total assets directly managed by the company climbed to \$25.7 billion at 2009 year's end, up from \$16.3 billion two years earlier. The number of individuals using its professional management service — meaning they've fully delegated portfolio decision-making to the company — rose to 391,000 at the end of last year from 322,000 at the end of 2008 and 227,500 in 2007.

History: Financial Engines was started by Nobel Laureate Dr. William F. Sharpe in 1996, along with Professor Joseph A. Grundfest, a former SEC commissioner and a professor of law at Stanford Law School, and the late Craig Johnson, then Chairman of the Venture Law Group. Drawing from years of Dr. Sharpe's research in the field of financial economics, the company launched its first online investment advisory service in 1998. It has raised approximately \$166M¹ from a roster of investors, including Oak Hill Capital Partners, New Enterprise Associates, American International Group, Chase Manhattan, Chase H&Q, ETrade, Goldman Sachs, Intel, Merrill Lynch, Thomas Weisel Partners, State Street Global Advisors, Washington Mutual, and Wells Fargo.

Products: At the heart of Financial Engines' offering are its in-house developed algorithms which compute the best fit solution/investment options for individual investors. The algorithms consider multiple indicators and then map the findings to individual investment/retirement related needs. These findings are then relayed to the customer, allowing them to make intelligent and informed decisions pertaining to their investments. Depending on the sponsor's (or individual's) subscription,

¹ Wall Street Journal, February 22, 2010

the solution includes various components like: forecasts, portfolio monitoring, tax-deferred accounts, stock options, and taxable account advice.

All these advisory services are delivered via web/email, telephone and face-to-face interactions. These solutions are packaged in the following manner:

- Professional Management - a discretionary managed account service designed for plan participants who want personalized and professional portfolio management services, investment advice, and retirement help from an independent investment advisor
- Online Advice - a nondiscretionary Internet-based service that offers personalized advice to plan participants who wish to take an active role in personally managing their retirement portfolios
- Retirement Evaluation - a retirement readiness assessment provided to plan participants upon plan rollout

The company plans to launch additional products that are specifically aimed at the vast number of “baby boomer” retirees who will be acutely concerned with the management of their retirement assets to ensure adequate income streams for their remaining years.

Business Model and Margins: Financial Engines sells its service to companies that pay a startup fee of anywhere from \$2,500 to \$50,000 and an annual fee of \$30 to \$50 per 401k enrollee. A retail customer (who is a direct customer and is not "sponsored" by their employer) can pay between \$150.00 to \$300.00 per year, depending on the type of service desired.

This model means that company revenues are largely recurring, and management should have excellent visibility regarding their near-term business momentum and medium-term revenue growth.

Financial Engine's core strength is its well-researched and continuously improved-upon algorithms based on mathematical modeling, and it needs to pro-actively invest in research and analysis. Also, it must continuously train customer facing executives who are involved in advising end clients.

There are major economies of scale in the asset management business in general, and these are even more pronounced in a company like Financial Engines where much of the decision making is done by algorithms and models. The company has been able to come public in large part because these economies started to generate substantial profits in 2009 versus prior losses for the company. As the company grows, their profit margins will increase further.

Management and Culture: Financial Engines was started by Nobel Laureate Dr. William F. Sharpe in 1996 along with Professor Joseph A. Grundfest, a former SEC commissioner and a professor of law at Stanford Law School, and the late Craig Johnson, then Chairman of the Venture Law Group. Sharpe stepped down as chairman of Financial Engines in 2003, remains on the board but is not active in day-to-day management of the firm.

Financial Engines' chief executive is 41-year-old Jeffrey N. Maggioncalda, a Stanford MBA who has been at the helm since he was 27. Apart from Maggioncalda, Kenneth M. Fine (Executive Vice President of Marketing), Garry W. Hallee (Executive Vice President of Technology and Service

Delivery) and others comprise the executive team. The company has an impressive Board with Paul G. Koontz serving as Chairman and Dr. William F. Sharpe continuing his role as Director Emeritus.

Most importantly, the management team and the Board have worked together for over a decade and it's fair to say that the company has been through a series of good and bad times. Key investors and board members like Dick Kramlich from NEA and Mark Wolfson from Oak Hill have been important assets to the company for both capital management expertise and connections.

Partners, Suppliers and Alliances: Working relationships with retirement plan providers and plan sponsors are a critical element of the Financial Engines business strategy, and also represent a competitive advantage and major obstacle for competition to surmount. This is a combination of technology and operational capabilities, brand marketing and historical performance.

The company has built linkages with plan providers to handle data exchange, transaction processing and fee sharing with the major firms including ACS, Fidelity, Hewitt, ING, JPMorgan, T.Rowe price and Vanguard. At the same time, the company is a established and safe brand for plan sponsors who are very conservative and risk averse. In some cases plan sponsors have made Financial Engines the sole provider of professional management services for their participants.

Competition: The huge size and attractive margins in asset management attract leagues of competition which Financial Engines faces on a few different fronts. One proceeds more directly from companies that offer investment advice to individual investors. Another comes in the form of alternatives like target-date retirement funds from established fund providers. Many of the larger household name companies offer these services including Fidelity, Vanguard, BlackRock and Merrill Lynch, as well as more specialized providers like Morningstar, GuidedChoice and ProManage, to name a few. Another level of competition comes from more general financial advisors which include a much broader array of services and offer investment advisory services as part of their overall offering. Lastly, other technology-focused companies like Invesra, FolioDynamix and BrightScope are in the competitive landscape.

OPPORTUNITIES AND THREATS

+ Retirement-oriented investment advisory services is a very large market in which Financial Engines has a differentiated approach and very low penetration.

+ Research shows that the more simple the retirement investing process is, the greater the participation rate, and by automating the decision making process Financial Engines helps both plan providers and plan sponsors.

+ As a greater segment of the population reaches retirement age, they will be more concerned with managing assets for income, which provides another large opportunity for Financial Engines.

+ The company has a scalable business structure and economies of scale that can drive increasing profit margins on future revenue growth which can generate high equity valuations.

- Returns generated by the Financial Engines models are respectable but not spectacular. Thus, they may not compare favorably to other more active approaches.

- The company has enjoyed large amounts of investment capital as a private company, and this may dull their edge in terms of cost control and expense management. This creates some possibility of a mismatch between public investor expectations and management execution.
- The ability of the company to expand outside the U.S. is not clear. However, with a public stock the company could certainly acquire one or more existing foreign firms. This brings the usual risks of dilution and increased execution risk.
- Retirement plan investing is heavily regulated by the government and this market is prone to short and long term government policies which can sometimes be disruptive to normal market functioning.

VALUATION

The enthusiasm for the shares has pushed the stock up towards our Intrinsic Value (IV) estimate of \$18. This figure still represents 10% upside from current levels. However, the nature of the Financial Engines business could justify even a longer-term assessment (we look out to 2015) and some investors with longer-term horizons may find the stock attractive even near our IV estimate.

In computing our Intrinsic Value (IV), we expect that the company revenue growth rate will decline into the mid-teens as the law of larger numbers takes hold. We assume stable gross margins and steady improvement in operating margins thanks to economies of scale. We project operating margin increasing from 19% currently to approximately 24% by 2015. Finally, we used a fairly aggressive 25 multiple due to the recurring nature of company revenues and high operating margins. [Please refer to Attachment A for more details.]

CONCLUSION

Financial Engines as an independent research and analysis company, focused on providing advisory services for better retirement solutions, is well poised to be a dominant player in this market.

2010 will continue to be a busy year following its successful IPO, and should bring it the required cash for expanding operations in its core areas of research and analysis as well as new customer acquisition. The company also has plans to productize its service based on mathematical modeling to service new market and sectors

We will monitor these elements of the story as the year progresses and provide periodic updates to the company's positioning and valuation as they develop. The first company quarterly report as a public company is coming up on May 11th, and then substantial lock-up agreements will be forthcoming which will release new shares into the market. (Although investors should take note that Goldman Sachs led this offering and has the ability to place these shares ahead of the stipulated lock-up period.)

Financial Engines, Inc.

FNGN

30-Apr-10

Price \$16.66

IV \$18.05

Delta 8%

Dec YE	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	FNGN	Ticker
Revenue	\$44	\$60	\$71	\$85	\$105	\$128	\$152	\$178	\$205	\$233	Nasdaq	Exchange
YoY Growth		36.9%	19.6%	19.3%	23.5%	21.9%	18.8%	17.1%	15.2%	13.7%	19%	Rev Growth
Gross Margin%	74.7%	71.7%	61.3%	67.0%	67.0%	67.0%	67.0%	67.0%	67.0%	67.0%	\$16.66	Current Price
Gross Profits	\$33	\$43	\$44	\$57	\$70	\$86	\$102	\$119	\$137	\$156	39	Shares Out
R&D%	32.7%	24.6%	19.2%	13.0%	13.0%	13.0%	13.0%	13.0%	13.0%	13.0%	1%	Avg. Dilution
R&D Expense	\$14	\$15	\$14	\$11	\$14	\$17	\$20	\$23	\$27	\$30	\$650	Cap (M)
SG&A%	56.0%	44.6%	39.1%	35.5%	35.0%	34.0%	33.0%	32.0%	31.0%	30.0%	\$70	Cash
SG&A Expense	\$24	\$27	\$28	\$30	\$37	\$44	\$50	\$57	\$64	\$70	\$0	Debt
Net Operating Margin	-13.9%	2.6%	3.1%	18.5%	19.0%	20.0%	21.0%	22.0%	23.0%	24.0%	30%	Tax Rate
Operating Income	-\$6	\$2	\$2	\$16	\$20	\$26	\$32	\$39	\$47	\$56	25	P/E Multiple
Taxed Operating Income	-\$4	\$1	\$2	\$11	\$14	\$18	\$22	\$27	\$33	\$39	15%	Discount Rate
Market Value Using P/E	-\$106	\$27	\$38	\$275	\$349	\$448	\$559	\$685	\$825	\$979		
Cash Position				\$70	\$90	\$116	\$147	\$187	\$234	\$290		
Shares (M)	39	39	39	39	40	40	41	41	41	42		
Period Share Price	-\$3	\$1	\$1	\$7	\$9	\$11	\$14	\$17	\$20	\$23		
PV of MV 4 Years Out	\$200	\$256	\$319	\$392	\$472	\$560					\$18.05	Intrinsic Value
PV of Cash 4 Years Out	\$51	\$66	\$84	\$107	\$134	\$166					8%	Up/Downside
PV MV + Cash	\$251	\$322	\$404	\$499	\$605	\$725						
PV Value Per Share	\$6.44	\$8.26	\$10.35	\$12.66	\$15.22	\$18.05						

Comparable Company Analysis
30-Apr-10

COMPANY	Ticker	Price	1 year change	3 month change	TEV	LTM Rev	LTM Growth	Gross Margin	Oper Margin	TEV / Revenue	Emps	Rev / Emp	Tags
Morningstar Inc.	MORN	\$48.07	21%	2%	2,009	479	-4.7%	73.1%	17.2%	4.2	2,600	184,229	Investment Advisory Services
FactSet Research Systems Inc.	FDS	\$74.93	40%	19%	3,291	622	1.5%	66.3%	23.6%	5.3	2,962	210,119	Financial Information Services
RiskMetrics Group, Inc.	RISK	\$22.58	30%	33%	1,637	303	2.4%	69.9%	10.3%	5.4	1,140	266,106	Risk Management Services
T. Rowe Price Group, Inc.	TROW	\$58.89	53%	19%	14,521	2,043	5.0%	58.7%	26.3%	7.1	4,802	425,510	Investment Management
Cohen & Steers Inc.	CNS	\$27.99	90%	38%	967	141	-9.2%	40.6%	15.3%	6.8	202	699,985	Investment Management
MSCI Inc.	MXB	\$35.46	69%	20%	3,654	459	6.2%	73.5%	20.2%	8.0	878	522,452	Investment Management Services
CyberSource Corporation	CYBS	\$25.77	76%	43%	1,697	265	15.8%	52.8%	4.1%	6.4	654	405,407	Transaction Processing Services
Digital River Inc.	DRIV	\$31.28	-19%	24%	840	404	2.4%	84.2%	12.3%	2.1	1,239	325,881	Transaction Processing Services
Salary.com, Inc.	SLRY	\$3.07	38%	37%	43	46	14.1%	69.0%	-49.0%	0.9	493	93,645	HR Management Services
Hewitt Associates Inc.	HEW	\$41.44	32%	5%	3,884	3,075	-4.0%	37.6%	8.7%	1.3	23,000	133,701	HR Management Services
Average			43.1%	23.8%			2.9%	62.6%	8.9%	4.7		326,704	
Financial Engines, Inc.	FNGN	\$16.66	NA	NA	646	85	19.2%	65.2%	6.7%	7.6	264	321,902	Investment Advisory Services

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ABOUT US

Research 2.0 specializes in positioning emerging technologies and companies in a business and investment context for institutional investors. The two founders each have over 30 years of experience in applying emerging technology, company research, equity capital markets and investment management.

Our clients consist of technology companies and institutional investors that rely on in-depth, independent, thematic research and advisory services.

Feel free to visit our website (www.research2zero.com) to learn more about us and [sign up for our free research update service](#).

Our main office is located at 1313 Washington St., #326, Boston MA 02118 U.S.A. and we have staff in New York, Connecticut and Paris, France. Our main telephone number is +1-617-848-9651.

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