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PIPER JAFFRAY COMPANIES
Form 10-Q
May 04, 2018

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended March 31, 2018
OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File No. 001-31720

PIPER JAFFRAY COMPANIES

(Exact Name of Registrant as specified in its Charter)

DELAWARE

(State or Other Jurisdiction of Incorporation or Organization)

800 Nicollet Mall, Suite 1000

Minneapolis, Minnesota

(Address of Principal Executive Offices)

30-0168701

(IRS Employer Identification No.)

55402

(Zip Code)

(612) 303-6000

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes " No }p

As of April 30, 2018, the registrant had 15,198,317 shares of Common Stock outstanding.

Piper Jaffray Companies
Index to Quarterly Report on Form 10-Q

PART I. FINANCIAL INFORMATION

ITEM 1. <u>FINANCIAL STATEMENTS</u>	<u>3</u>
<u>Consolidated Statements of Financial Condition as of March 31, 2018 (Unaudited) and December 31, 2017</u>	<u>3</u>
<u>Consolidated Statements of Operations for the three months ended March 31, 2018 and March 31, 2017 (Unaudited)</u>	<u>4</u>
<u>Consolidated Statements of Comprehensive Income for the three months ended March 31, 2018 and March 31, 2017 (Unaudited)</u>	<u>5</u>
<u>Consolidated Statements of Cash Flows for the three months ended March 31, 2018 and March 31, 2017 (Unaudited)</u>	<u>6</u>
<u>Notes to the Consolidated Financial Statements (Unaudited)</u>	<u>8</u>
ITEM 2. <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	<u>37</u>
ITEM 3. <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	<u>60</u>
ITEM 4. <u>CONTROLS AND PROCEDURES</u>	<u>60</u>

PART II. OTHER INFORMATION

ITEM 1. <u>LEGAL PROCEEDINGS</u>	<u>60</u>
ITEM 1A. <u>RISK FACTORS</u>	<u>60</u>
ITEM 2. <u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	<u>61</u>
ITEM 6. <u>EXHIBITS</u>	<u>61</u>
<u>SIGNATURES</u>	<u>62</u>

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

Piper Jaffray Companies

Consolidated Statements of Financial Condition

	March 31, 2018	December 31, 2017
	(Unaudited)	
(Amounts in thousands, except share data)		
Assets		
Cash and cash equivalents	\$27,642	\$ 33,793
Receivables from brokers, dealers and clearing organizations	46,302	145,394
Financial instruments and other inventory positions owned	529,943	663,330
Financial instruments and other inventory positions owned and pledged as collateral	503,860	720,047
Total financial instruments and other inventory positions owned	1,033,803	1,383,377
Fixed assets (net of accumulated depreciation and amortization of \$58,059 and \$55,944, respectively)	24,787	25,179
Goodwill	81,855	81,855
Intangible assets (net of accumulated amortization of \$88,032 and \$85,417, respectively)	20,219	22,834
Investments	169,739	176,212
Net deferred income tax assets	95,595	101,205
Other assets	77,424	54,834
Total assets	\$1,577,366	\$ 2,024,683
Liabilities and Shareholders' Equity		
Short-term financing	\$ 186,254	\$ 289,937
Senior notes	125,000	125,000
Payables to brokers, dealers and clearing organizations	33,582	19,392
Financial instruments and other inventory positions sold, but not yet purchased	320,469	399,227
Accrued compensation	127,351	400,092
Other liabilities and accrued expenses	49,703	49,800
Total liabilities	842,359	1,283,448
Shareholders' equity:		
Common stock, \$0.01 par value:		
Shares authorized: 100,000,000 at March 31, 2018 and December 31, 2017;		
Shares issued: 19,513,856 at March 31, 2018 and 19,512,914 at December 31, 2017;		
Shares outstanding: 13,298,825 at March 31, 2018 and 12,911,149 at December 31, 2017	195	195
Additional paid-in capital	802,566	791,970
Retained earnings (1)	152,701	176,270
Less common stock held in treasury, at cost: 6,215,031 at March 31, 2018 and 6,601,765 shares at December 31, 2017	(266,720)	(273,824)
Accumulated other comprehensive loss	(750)	(1,279)
Total common shareholders' equity	687,992	693,332
Noncontrolling interests	47,015	47,903
Total shareholders' equity	735,007	741,235

Total liabilities and shareholders' equity	\$1,577,366	\$2,024,683
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(1) Includes the cumulative effect adjustment upon adoption of ASU 2014-09, as amended. See Note 2 for further discussion.

See Notes to the Consolidated Financial Statements

3

Table of ContentsPiper Jaffray Companies
Consolidated Statements of Operations
(Unaudited)

(Amounts in thousands, except per share data)	Three Months Ended	
	March 31, 2018	2017
Revenues:		
Investment banking	\$120,841	\$132,250
Institutional brokerage	27,645	39,136
Asset management	12,589	16,007
Interest	10,413	7,719
Investment income	2,912	10,375
Total revenues	174,400	205,487
Interest expense	5,338	4,958
Net revenues	169,062	200,529
Non-interest expenses:		
Compensation and benefits	115,170	134,378
Outside services	8,939	10,328
Occupancy and equipment	8,578	8,462
Communications	8,626	7,616
Marketing and business development	7,299	7,547
Deal-related expenses	5,051	—
Trade execution and clearance	2,163	1,811
Intangible asset amortization	2,615	3,822
Back office conversion costs	—	866
Other operating expenses	2,583	2,890
Total non-interest expenses	161,024	177,720
Income before income tax benefit	8,038	22,809
Income tax benefit	(2,581)	(395)
Net income	10,619	23,204
Net income applicable to noncontrolling interests	16	2,929
Net income applicable to Piper Jaffray Companies	\$10,603	\$20,275
Net income applicable to Piper Jaffray Companies' common shareholders	\$6,435	\$16,828
Earnings per common share		
Basic	\$0.47	\$1.33
Diluted	\$0.47	\$1.31

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Dividends declared per common share	\$2.00	\$0.31
Weighted average number of common shares outstanding		
Basic	13,096	12,594
Diluted	13,382	12,922

See Notes to the Consolidated Financial Statements

4

Table of Contents

Piper Jaffray Companies

Consolidated Statements of Comprehensive Income

(Unaudited)

(Amounts in thousands)	Three Months Ended March 31,	
	2018	2017
Net income	\$10,619	\$23,204
Other comprehensive income, net of tax:		
Foreign currency translation adjustment	529	223
Comprehensive income	11,148	23,427
Comprehensive income applicable to noncontrolling interests	16	2,929
Comprehensive income applicable to Piper Jaffray Companies	\$11,132	\$20,498

See Notes to the Consolidated Financial Statements

Table of ContentsPiper Jaffray Companies
Consolidated Statements of Cash Flows
(Unaudited)

	Three Months Ended March 31,	
(Dollars in thousands)	2018	2017
Operating Activities:		
Net income	\$ 10,619	\$ 23,204
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of fixed assets	2,003	1,703
Deferred income taxes	5,610	13,916
Stock-based compensation	8,970	4,676
Amortization of intangible assets	2,615	3,822
Amortization of forgivable loans	1,298	1,820
Decrease/(increase) in operating assets:		
Receivables:		
Customers	—	8,428
Brokers, dealers and clearing organizations	99,092	18,444
Securities purchased under agreements to resell	—	(71,423)
Net financial instruments and other inventory positions owned	270,816	145,860
Investments	6,473	8,382
Other assets	(23,256)	(14,170)
Increase/(decrease) in operating liabilities:		
Payables:		
Customers	—	12,242
Brokers, dealers and clearing organizations	14,190	163,221
Securities sold under agreements to repurchase	—	(480)
Accrued compensation	(247,363)	(153,843)
Other liabilities and accrued expenses	(4,619)	(1,993)
Net cash provided by operating activities	146,448	163,809
Investing Activities:		
Purchases of fixed assets, net	(1,560)	(1,756)
Net cash used in investing activities	(1,560)	(1,756)

Continued on next page

Table of Contents

Piper Jaffray Companies

Consolidated Statements of Cash Flows – Continued

(Unaudited)

(Dollars in thousands)	Three Months Ended	
	March 31, 2018	2017
Financing Activities:		
Decrease in short-term financing	\$(103,683)	\$(121,686)
Payment of cash dividend	(30,375)	(4,746)
Decrease in noncontrolling interests	(904)	(16,154)
Repurchase of common stock	(16,797)	(19,788)
Proceeds from stock option exercises	—	1,703
Net cash used in financing activities	(151,759)	(160,671)
Currency adjustment:		
Effect of exchange rate changes on cash	720	145
Net increase/(decrease) in cash, cash equivalents and restricted cash (1)	(6,151)	1,527
Cash, cash equivalents and restricted cash at beginning of period (1)	33,793	70,374
Cash, cash equivalents and restricted cash at end of period (1)	\$27,642	\$71,901
Supplemental disclosure of cash flow information –		
Cash paid during the period for:		
Interest	\$5,615	\$4,464
Income taxes	\$12,474	\$7,710

(1) Upon adoption of ASU 2016-18, restricted cash includes cash and cash equivalents previously segregated for regulatory purposes. See Note 2 for further discussion.

See Notes to the Consolidated Financial Statements

Table of Contents

Piper Jaffray Companies
 Notes to the Consolidated Financial Statements
 (Unaudited)

Index

Note 1	<u>Organization and Basis of Presentation</u>	9
Note 2	<u>Accounting Policies and Pronouncements</u>	10
Note 3	<u>Financial Instruments and Other Inventory Positions Owned and Financial Instruments and Other Inventory Positions Sold, but Not Yet Purchased</u>	13
Note 4	<u>Fair Value of Financial Instruments</u>	15
Note 5	<u>Variable Interest Entities</u>	21
Note 6	<u>Receivables from and Payables to Brokers, Dealers and Clearing Organizations</u>	22
Note 7	<u>Investments</u>	23
Note 8	<u>Other Assets</u>	24
Note 9	<u>Short-Term Financing</u>	24
Note 10	<u>Contingencies, Commitments and Guarantees</u>	25
Note 11	<u>Shareholders' Equity</u>	26
Note 12	<u>Compensation Plans</u>	28
Note 13	<u>Earnings Per Share</u>	33
Note 14	<u>Segment Reporting</u>	34
Note 15	<u>Net Capital Requirements and Other Regulatory Matters</u>	36
Note 16	<u>Income Taxes</u>	36

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Note 1 Organization and Basis of Presentation

Organization

Piper Jaffray Companies is the parent company of Piper Jaffray & Co. ("Piper Jaffray"), a securities broker dealer and investment banking firm; Piper Jaffray Ltd., a firm providing securities brokerage and mergers and acquisitions services in Europe; Piper Jaffray Finance LLC, which facilitates corporate debt underwriting in conjunction with affiliated credit vehicles; Advisory Research, Inc. ("ARI"), which provides asset management services to separately managed accounts, closed-end and open-end funds and partnerships; Piper Jaffray Investment Group Inc. and PJC Capital Management LLC, which consist of entities providing alternative asset management services; Piper Jaffray Financial Products Inc. and Piper Jaffray Financial Products II Inc., entities that facilitate derivative transactions; and other immaterial subsidiaries.

Effective August 7, 2017, Piper Jaffray transitioned from a self clearing securities broker dealer to a fully disclosed clearing model. Pershing LLC ("Pershing") is Piper Jaffray's clearing broker dealer responsible for the clearance and settlement of firm and customer cash and security transactions.

Piper Jaffray Companies and its subsidiaries (collectively, the "Company") operate in two reporting segments: Capital Markets and Asset Management. A summary of the activities of each of the Company's business segments is as follows:

Capital Markets

The Capital Markets segment provides investment banking services and institutional sales, trading and research services. Investment banking services include financial advisory services, management of and participation in underwritings and public finance activities. Revenues are generated through the receipt of advisory and financing fees. Institutional sales, trading and research services focus on the trading of equity and fixed income products with institutions, government and non-profit entities. Revenues are generated through commissions and sales credits earned on equity and fixed income institutional sales activities, net interest revenues on trading securities held in inventory, and profits and losses from trading these securities. Also, the Company generates revenue through strategic trading and investing activities, which focus on investments in municipal bonds, U.S. government agency securities, and merchant banking activities involving equity or debt investments in late stage private companies. The Company has created alternative asset management funds in merchant banking, energy and senior living in order to invest firm capital and to manage capital from outside investors. The Company receives management and performance fees for managing these funds.

Asset Management

The Asset Management segment provides traditional asset management services with product offerings in master limited partnerships and equity securities to institutions and individuals. Revenues are generated in the form of management and performance fees. Revenues are also generated through investments in the partnerships and funds that the Company manages.

Basis of Presentation

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The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") for interim financial information and the rules and regulations of the Securities and Exchange Commission ("SEC"). Pursuant to this guidance, certain information and disclosures have been omitted that are included within complete annual financial statements. Except as disclosed herein, there have been no material changes in the information reported in the financial statements and related disclosures in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

The consolidated financial statements include the accounts of Piper Jaffray Companies, its wholly owned subsidiaries, and all other entities in which the Company has a controlling financial interest. Noncontrolling interests represent equity interests in consolidated entities that are not attributable, either directly or indirectly, to Piper Jaffray Companies. Noncontrolling interests include the minority equity holders' proportionate share of the equity in the Company's alternative asset management funds. All material intercompany balances have been eliminated.

Management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates and assumptions are based on the best information available, actual results could differ from those estimates.

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Note 2 Accounting Policies and Pronouncements

Summary of Significant Accounting Policies

Refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2017 for a full description of the Company's significant accounting policies. Changes to the Company's significant accounting policies are described below.

Revenue Recognition

Investment Banking – Investment banking revenues, which include advisory and underwriting fees, are recorded when the performance obligation for the transaction is satisfied under the terms of each engagement. Expenses associated with such transactions are deferred until the related revenue is recognized or the engagement is otherwise concluded. Investment banking revenues are presented gross of related client reimbursed deal expenses. Expenses for completed deals are reported separately in deal-related expenses on the consolidated statements of operations. Expenses related to investment banking deals not completed are recognized as non-interest expenses on the consolidated statements of operations.

The Company's advisory fees generally consist of a nonrefundable up-front fee and a success fee. The nonrefundable fee is recorded as deferred revenue upon receipt and recognized at a point in time when the performance obligation is satisfied, or when the transaction is deemed by management to be terminated. Management's judgment is required in determining when a transaction is considered to be terminated.

The substantial majority of the Company's advisory and underwriting fees (i.e., the success related advisory fee) are considered variable consideration and recognized when it is probable that the variable consideration will not be reversed in a future period. The variable consideration is considered to be constrained until satisfaction of the performance obligation. The Company's performance obligation is generally satisfied at a point in time upon the closing of a strategic transaction, completion of a financing or underwriting arrangement, or some other defined outcome. At this time, the Company has transferred control of the promised service and the customer obtains control. As these arrangements represent a single performance obligation, allocation of the transaction price is not necessary. The Company has elected to apply the following optional exemptions regarding disclosure of its remaining performance obligations: (i) the Company's performance obligation is part of a contract that has an original expected duration of one year or less and/or (ii) the variable consideration is allocated entirely to a wholly unsatisfied promise to transfer a distinct service that forms part of a single performance obligation.

Institutional Brokerage – Institutional brokerage revenues include (i) commissions received from customers for the execution of brokerage transactions in listed and over-the-counter (OTC) equity, fixed income and convertible debt securities, which are recognized at a point in time on the trade date because the customer has obtained the rights to the underlying security provided by the trade execution service, (ii) trading gains and losses, recorded on changes in the fair value of long and short security positions in the reporting period and (iii) fees received by the Company for equity research, which are generally recognized in the period received. The Company permits institutional customers to allocate a portion of their gross commissions to pay for research products and other services provided by third parties. The amounts allocated for those purposes are commonly referred to as soft dollar arrangements. As the Company is not acting as a principal in satisfying the performance obligation for these arrangements, expenses relating to soft dollars are netted against commission revenues and included in other liabilities and accrued expenses on the consolidated statements of financial condition.

Asset Management – Asset management fees include revenues the Company receives in connection with management and investment advisory services performed for separately managed accounts and various funds and partnerships. The performance obligation related to the transfer of these services is satisfied over time and the related fees are recognized under the output method, which reflects the fees that the Company has a right to invoice based on the services provided during the period. Fees are defined in client contracts as a percentage of portfolio assets under management. Amounts related to remaining performance obligations are not disclosed as the Company applies the output method.

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Asset management revenues may also include performance fees. Performance fees, if earned, are recognized when it is probable that such revenue will not be reversed in a future period. For the Company's alternative asset management funds, management will consider such factors as the remaining assets and residual life of the fund to conclude whether it is probable that a significant reversal of revenue will not occur in the future. For the Company's traditional asset management funds, performance fees are earned when the investment return on assets under management exceeds certain benchmark targets or other performance targets over a specified measurement period (monthly, quarterly or annually). These performance fees are typically annual performance hurdles and recognized in the fourth quarter of the applicable year, or upon client liquidation.

Adoption of New Accounting Standards

Revenue Recognition

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" ("ASU 2014-09"), which supersedes previous revenue recognition guidance, including most industry-specific guidance. ASU 2014-09, as amended, requires a company to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services, and also requires enhanced disclosures.

The Company adopted this guidance effective as of January 1, 2018 under the modified retrospective method, in which the cumulative effect of applying the standard was recognized at the date of initial application. The cumulative effect adjustment that the Company recognized upon adoption as of January 1, 2018 was a decrease to retained earnings of \$3.6 million, net of tax. The Company applied the guidance only to those contracts that were not completed at the date of initial application.

The previous broker dealer industry treatment of netting deal expenses with investment banking revenues was superseded under the new guidance. As a result of adopting ASU 2014-09, the Company now presents investment banking revenues gross of related client reimbursed deal expenses and deal-related expenses as non-interest expenses on the consolidated statements of operations, rather than the previous presentation of netting deal expenses incurred for completed investment banking deals within revenues. For the three months ended March 31, 2018, the Company reported higher investment banking revenues and higher non-compensation expenses of \$5.1 million, respectively. This change did not impact earnings. In addition, the Company now defers the recognition of performance fees on its merchant banking, energy and senior living alternative asset management funds until such fees are no longer subject to reversal, which will cause a delay in the recognition of these fees as revenue. For the three months ended March 31, 2018, the amount of asset management revenue from performance fees that the Company would have recognized if not for this change was not material. With the exception of the above, the Company's previous methods of recognizing investment banking revenues were not significantly impacted by the new guidance.

Recognition and Measurement of Financial Assets and Financial Liabilities

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU 2016-01"). The amendments in ASU 2016-01 address certain aspects of the recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 became effective for the Company as of January 1, 2018. There was no material impact to the Company's results of operations, financial position or disclosures upon adoption as the Company's financial instruments are

already recorded at fair value.

Statement of Cash Flows

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments" ("ASU 2016-15"). ASU 2016-15 clarifies how entities should classify certain cash receipts and cash payments on the statement of cash flows. The amendments in ASU 2016-15 became effective for the Company as of January 1, 2018, with retrospective application. There was no material impact to the Company's presentation of its consolidated statements of cash flows upon adoption of ASU 2016-15.

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

In November 2016, the FASB issued ASU No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash" ("ASU 2016-18"). Under ASU 2016-18, restricted cash will be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period amounts shown on the consolidated statements of cash flows. ASU 2016-18 became effective for the Company as of January 1, 2018, with retrospective application. As a registered broker dealer, Piper Jaffray is subject to Rule 15c3-3 of the Securities Exchange Act of 1934, which requires broker dealers carrying customer accounts to maintain cash or qualified securities in a segregated reserve account for the exclusive benefit of its customers. These accounts were previously classified as cash and cash equivalents segregated for regulatory purposes on the consolidated statements of financial condition. Subsequent to transitioning to a fully disclosed clearing model in 2017, Piper Jaffray no longer carries customer accounts and is no longer subject to Rule 15c3-3. The following table provides a reconciliation of cash, cash equivalents and restricted cash for all periods presented on the consolidated statements of cash flows:

	December 31, 2017	March 31, 2017	December 31, 2016
(Dollars in thousands)			
Cash and cash equivalents	\$ 33,793	\$ 18,879	\$ 41,359
Cash and cash equivalents segregated for regulatory purposes	—	53,022	29,015
Cash, cash equivalents and restricted cash	\$ 33,793	\$ 71,901	\$ 70,374

Future Adoption of New Applicable Accounting Standards

Leases

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)" ("ASU 2016-02"). ASU 2016-02 requires lessees to recognize a right-of-use asset and lease liability on the consolidated statements of financial position and disclose key information about leasing arrangements. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee have not significantly changed from current U.S. GAAP. ASU 2016-02 is effective for annual and interim periods beginning after December 15, 2018. As of March 31, 2018, the Company had approximately 65 operating leases for office space with aggregate minimum lease commitments of \$78.7 million. Upon adoption, this lease commitment will be reflected on the statement of financial condition as a right-of-use asset and a lease commitment liability. The Company is evaluating other service contracts which may include embedded leases, however, the Company does not expect these to be material. Upon adoption of ASU 2016-02, the Company does not expect material changes to the recognition of rent expense in its consolidated statements of operations. The impact of the new guidance on Piper Jaffray's net capital is expected to be minimal.

Financial Instruments – Credit Losses

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" ("ASU 2016-13"). The new guidance requires an entity to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts as opposed to delaying recognition until the loss was probable of occurring. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019. Early adoption is permitted for annual and interim periods beginning after December 15, 2018. The Company does not expect the adoption of ASU 2016-13 to have a material impact on its consolidated financial statements.

Table of Contents

Piper Jaffray Companies
Notes to the Consolidated Financial Statements
(Unaudited)

Note 3 Financial Instruments and Other Inventory Positions Owned and Financial Instruments and Other Inventory Positions Sold, but Not Yet Purchased

(Dollars in thousands)	March 31, 2018	December 31, 2017
Financial instruments and other inventory positions owned:		
Corporate securities:		
Equity securities	\$ 16,009	\$ 51,896
Convertible securities	90,841	74,456
Fixed income securities	35,582	30,145
Municipal securities:		
Taxable securities	50,346	67,699
Tax-exempt securities	449,016	744,241
Short-term securities	113,775	62,251
Mortgage-backed securities	284	481
U.S. government agency securities	258,684	317,318
U.S. government securities	299	9,317
Derivative contracts	18,967	25,573
Total financial instruments and other inventory positions owned	\$ 1,033,803	\$ 1,383,377
Financial instruments and other inventory positions sold, but not yet purchased:		
Corporate securities:		
Equity securities	\$ 77,542	\$ 101,517
Fixed income securities	29,998	30,292
U.S. government agency securities	23,674	49,077
U.S. government securities	185,010	213,312
Derivative contracts	4,245	5,029
Total financial instruments and other inventory positions sold, but not yet purchased	\$ 320,469	\$ 399,227

At March 31, 2018 and December 31, 2017, financial instruments and other inventory positions owned in the amount of \$503.9 million and \$720.0 million, respectively, had been pledged as collateral for short-term financings.

Financial instruments and other inventory positions sold, but not yet purchased represent obligations of the Company to deliver the specified security at the contracted price, thereby creating a liability to purchase the security in the market at prevailing prices. The Company is obligated to acquire the securities sold short at prevailing market prices, which may exceed the amount reflected on the consolidated statements of financial condition. The Company economically hedges changes in the market value of its financial instruments and other inventory positions owned using inventory positions sold, but not yet purchased, interest rate derivatives, credit default swap index contracts, U.S. treasury bond futures and exchange traded options.

Derivative Contract Financial Instruments

The Company uses interest rate swaps, interest rate locks, credit default swap index contracts, U.S. treasury bond futures and equity option contracts as a means to manage risk in certain inventory positions. The Company also enters into interest rate swaps to facilitate customer transactions. The following describes the Company's derivatives by the type of transaction or security the instruments are economically hedging.

Customer matched-book derivatives: The Company enters into interest rate derivative contracts in a principal capacity as a dealer to satisfy the financial needs of its customers. The Company simultaneously enters into an interest rate derivative contract with a third party for the same notional amount to hedge the interest rate and credit risk of the initial client interest rate derivative contract. In certain limited instances, the Company has only hedged interest rate risk with a third party, and retains uncollateralized credit risk as described below. The instruments use interest rates based upon either the London Interbank Offer Rate ("LIBOR") index or the Securities Industry and Financial Markets Association ("SIFMA") index.

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Trading securities derivatives: The Company enters into interest rate derivative contracts and uses U.S. treasury bond futures to hedge interest rate and market value risks associated with its fixed income securities. These instruments use interest rates based upon either the Municipal Market Data ("MMD") index, LIBOR or the SIFMA index. The Company also enters into credit default swap index contracts to hedge credit risk associated with its taxable fixed income securities and option contracts to hedge market value risk associated with its convertible securities.

Derivatives are reported on a net basis by counterparty (i.e., the net payable or receivable for derivative assets and liabilities for a given counterparty) when a legal right of offset exists and on a net basis by cross product when applicable provisions are stated in master netting agreements. Cash collateral received or paid is netted on a counterparty basis, provided a legal right of offset exists. The total absolute notional contract amount, representing the absolute value of the sum of gross long and short derivative contracts, provides an indication of the volume of the Company's derivative activity and does not represent gains and losses. The following table presents the gross fair market value and the total absolute notional contract amount of the Company's outstanding derivative instruments, prior to counterparty netting, by asset or liability position:

Derivative Category	March 31, 2018			December 31, 2017		
	Derivative Assets	Derivative Liabilities	Notional Amount	Derivative Assets	Derivative Liabilities	Notional Amount
	(1)	(2)		(1)	(2)	
Interest rate						
Customer matched-book	\$ 194,735	\$ 182,472	\$ 2,682,335	\$ 239,224	\$ 225,890	\$ 2,819,006
Trading securities	2,393	1,389	455,775	126	4,459	399,450
Equity options						
Trading securities	—	—	—	6	—	9,635
	\$ 197,128	\$ 183,861	\$ 3,138,110	\$ 239,356	\$ 230,349	\$ 3,228,091

(1) Derivative assets are included within financial instruments and other inventory positions owned on the consolidated statements of financial condition.

(2) Derivative liabilities are included within financial instruments and other inventory positions sold, but not yet purchased on the consolidated statements of financial condition.

The Company's derivative contracts do not qualify for hedge accounting, therefore, unrealized gains and losses are recorded on the consolidated statements of operations. The gains and losses on the related economically hedged inventory positions are not disclosed below as they are not in qualifying hedging relationships. The following table presents the Company's unrealized gains/(losses) on derivative instruments:

Derivative Category	Operations Category	Three Months Ended	
		March 31,	
		2018	2017
Interest rate derivative contract	Investment banking	\$(795)	\$(292)
Interest rate derivative contract	Institutional brokerage	5,062	(14,738)
Credit default swap index contract	Institutional brokerage	—	255
		\$4,267	\$(14,775)

Credit risk associated with the Company's derivatives is the risk that a derivative counterparty will not perform in accordance with the terms of the applicable derivative contract. Credit exposure associated with the Company's derivatives is driven by uncollateralized market movements in the fair value of the contracts with counterparties and is monitored regularly by the Company's financial risk committee. The Company considers counterparty credit risk in

determining derivative contract fair value. The majority of the Company's derivative contracts are substantially collateralized by its counterparties, who are major financial institutions. The Company has a limited number of counterparties who are not required to post collateral. Based on market movements, the uncollateralized amounts representing the fair value of the derivative contract can become material, exposing the Company to the credit risk of these counterparties. As of March 31, 2018, the Company had \$17.0 million of uncollateralized credit exposure with these counterparties (notional contract amount of \$179.9 million), including \$12.9 million of uncollateralized credit exposure with one counterparty.

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Note 4 Fair Value of Financial Instruments

Based on the nature of the Company's business and its role as a "dealer" in the securities industry or as a manager of alternative asset management funds, the fair values of its financial instruments are determined internally. The Company's processes are designed to ensure that the fair values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, unobservable inputs are developed based on an evaluation of all relevant empirical market data, including prices evidenced by market transactions, interest rates, credit spreads, volatilities and correlations and other security-specific information. Valuation adjustments related to illiquidity or counterparty credit risk are also considered. In estimating fair value, the Company may utilize information provided by third party pricing vendors to corroborate internally-developed fair value estimates.

The Company employs specific control processes to determine the reasonableness of the fair value of its financial instruments. The Company's processes are designed to ensure that the internally-estimated fair values are accurately recorded and that the data inputs and the valuation techniques used are appropriate, consistently applied, and that the assumptions are reasonable and consistent with the objective of determining fair value. Individuals outside of the trading departments perform independent pricing verification reviews as of each reporting date. The Company has established parameters which set forth when the fair value of securities are independently verified. The selection parameters are generally based upon the type of security, the level of estimation risk of a security, the materiality of the security to the Company's financial statements, changes in fair value from period to period, and other specific facts and circumstances of the Company's securities portfolio. In evaluating the initial internally-estimated fair values made by the Company's traders, the nature and complexity of securities involved (e.g., term, coupon, collateral, and other key drivers of value), level of market activity for securities, and availability of market data are considered. The independent price verification procedures include, but are not limited to, analysis of trade data (both internal and external where available), corroboration to the valuation of positions with similar characteristics, risks and components, or comparison to an alternative pricing source, such as a discounted cash flow model. The Company's valuation committee, comprised of members of senior management and risk management, provides oversight and overall responsibility for the internal control processes and procedures related to fair value measurements.

The following is a description of the valuation techniques used to measure fair value.

Cash Equivalents

Cash equivalents include highly liquid investments with original maturities of 90 days or less. Actively traded money market funds are measured at their net asset value and classified as Level I.

Financial Instruments and Other Inventory Positions Owned

The Company records financial instruments and other inventory positions owned and financial instruments and other inventory positions sold, but not yet purchased at fair value on the consolidated statements of financial condition with unrealized gains and losses reflected on the consolidated statements of operations.

Equity securities – Exchange traded equity securities are valued based on quoted prices from the exchange for identical assets or liabilities as of the period-end date. To the extent these securities are actively traded and valuation adjustments are not applied, they are categorized as Level I. Non-exchange traded equity securities (principally hybrid preferred securities) are measured primarily using broker quotations, prices observed for recently executed market

transactions and internally-developed fair value estimates based on observable inputs and are categorized within Level II of the fair value hierarchy.

Convertible securities – Convertible securities are valued based on observable trades, when available. Accordingly, these convertible securities are categorized as Level II.

Corporate fixed income securities – Fixed income securities include corporate bonds which are valued based on recently executed market transactions of comparable size, internally-developed fair value estimates based on observable inputs, or broker quotations. Accordingly, these corporate bonds are categorized as Level II.

Taxable municipal securities – Taxable municipal securities are valued using recently executed observable trades or market price quotations and therefore are generally categorized as Level II.

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Tax-exempt municipal securities – Tax-exempt municipal securities are valued using recently executed observable trades or market price quotations and therefore are generally categorized as Level II. Certain illiquid tax-exempt municipal securities are valued using market data for comparable securities (maturity and sector) and management judgment to infer an appropriate current yield or other model-based valuation techniques deemed appropriate by management based on the specific nature of the individual security and are therefore categorized as Level III.

Short-term municipal securities – Short-term municipal securities include auction rate securities, variable rate demand notes, and other short-term municipal securities. Variable rate demand notes and other short-term municipal securities are valued using recently executed observable trades or market price quotations and therefore are generally categorized as Level II. Auction rate securities with limited liquidity are categorized as Level III and are valued using discounted cash flow models with unobservable inputs such as the Company's expected recovery rate on the securities.

Mortgage-backed securities – Mortgage-backed securities are valued using observable trades, when available. Certain mortgage-backed securities are valued using models where inputs to the model are directly observable in the market, or can be derived principally from or corroborated by observable market data. To the extent we hold, these mortgage-backed securities are categorized as Level II. Certain mortgage-backed securities collateralized by residential mortgages are valued using cash flow models that utilize unobservable inputs including credit default rates, prepayment rates, loss severity and valuation yields. As judgment is used to determine the range of these inputs, these mortgage-backed securities are categorized as Level III.

U.S. government agency securities – U.S. government agency securities include agency debt bonds and mortgage bonds. Agency debt bonds are valued by using either direct price quotes or price quotes for comparable bond securities and are categorized as Level II. Mortgage bonds include bonds secured by mortgages, mortgage pass-through securities, agency collateralized mortgage-obligation ("CMO") securities and agency interest-only securities. Mortgage pass-through securities, CMO securities and interest-only securities are valued using recently executed observable trades or other observable inputs, such as prepayment speeds and therefore are generally categorized as Level II. Mortgage bonds are valued using observable market inputs, such as market yields ranging from 293-348 basis points ("bps") on spreads over U.S. treasury securities, or models based upon prepayment expectations ranging from 0%-13% conditional prepayment rate ("CPR"). These securities are categorized as Level II.

U.S. government securities – U.S. government securities include highly liquid U.S. treasury securities which are generally valued using quoted market prices and therefore categorized as Level I. The Company does not transact in securities of countries other than the U.S. government.

Derivatives – Derivative contracts include interest rate swaps, interest rate locks, credit default swap index contracts, U.S. treasury bond futures and equity option contracts. These instruments derive their value from underlying assets, reference rates, indices or a combination of these factors. The Company's equity option derivative contracts are valued based on quoted prices from the exchange for identical assets or liabilities as of the period-end date. To the extent these contracts are actively traded and valuation adjustments are not applied, they are categorized as Level I. The Company's credit default swap index contracts are valued using market price quotations and are classified as Level II. The majority of the Company's interest rate derivative contracts, including both interest rate swaps and interest rate locks, are valued using market standard pricing models based on the net present value of estimated future cash flows. The valuation models used do not involve material subjectivity as the methodologies do not entail significant judgment and the pricing inputs are market observable, including contractual terms, yield curves and measures of volatility. These instruments are classified as Level II within the fair value hierarchy. Certain interest rate locks transact in less active markets and were valued using valuation models that included the previously mentioned

observable inputs and certain unobservable inputs that required significant judgment, such as the premium over the MMD curve. These instruments are classified as Level III.

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

Investments

The Company's investments valued at fair value include equity investments in private companies and partnerships, investments in registered mutual funds, warrants of public and private companies and private company debt. Investments in registered mutual funds are valued based on quoted prices on active markets and classified as Level I. Company-owned warrants, which have a cashless exercise option, are valued based upon the Black-Scholes option-pricing model and certain unobservable inputs. The Company applies a liquidity discount to the value of its warrants in public and private companies. For warrants in private companies, valuation adjustments, based upon management's judgment, are made to account for differences between the measured security and the stock volatility factors of comparable companies. Company-owned warrants are reported as Level III assets. Investments in private companies are valued based on an assessment of each underlying security, considering rounds of financing, third party transactions and market-based information, including comparable company transactions, trading multiples (e.g., multiples of revenue and earnings before interest, taxes, depreciation and amortization ("EBITDA")) and changes in market outlook, among other factors. These securities are generally categorized as Level III.

Fair Value Option – The fair value option permits the irrevocable fair value option election on an instrument-by-instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. The fair value option was elected for certain merchant banking and other investments at inception to reflect economic events in earnings on a timely basis. Merchant banking and other equity investments of \$15.0 million and \$14.1 million, included within investments on the consolidated statements of financial condition, are accounted for at fair value and are classified as Level III assets at March 31, 2018 and December 31, 2017, respectively. The realized and unrealized net gains from fair value changes included in earnings as a result of electing to apply the fair value option to certain financial assets were \$0.8 million and \$0.5 million for the three months ended March 31, 2018 and 2017, respectively.

The following table summarizes quantitative information about the significant unobservable inputs used in the fair value measurement of the Company's Level III financial instruments as of March 31, 2018:

	Valuation Technique	Unobservable Input	Range	Weighted Average
Assets:				
Financial instruments and other inventory positions owned:				
Derivative contracts:				
Interest rate locks	Discounted cash flow	Premium over the MMD curve (1)	2 - 38 bps	23.8 bps
Investments at fair value:				
Equity securities in private companies	Market approach	Revenue multiple (2)	2 - 5 times	4.2 times
		EBITDA multiple (2)	11 - 15 times	12.4 times
Liabilities:				
Financial instruments and other inventory positions sold, but not yet purchased:				
Derivative contracts:				
Interest rate locks	Discounted cash flow	Premium over the MMD curve (1)	2 - 36 bps	13.6 bps

Sensitivity of the fair value to changes in unobservable inputs:

- (1) Significant increase/(decrease) in the unobservable input in isolation would result in a significantly lower/(higher) fair value measurement.
- (2) Significant increase/(decrease) in the unobservable input in isolation would result in a significantly higher/(lower) fair value measurement.

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

The following table summarizes the valuation of the Company's financial instruments by pricing observability levels defined in FASB Accounting Standards Codification Topic 820, "Fair Value Measurement" ("ASC 820") as of March 31, 2018:

(Dollars in thousands)	Level I	Level II	Level III	Counterparty and Cash Collateral Netting (1)	Total
Assets:					
Financial instruments and other inventory positions owned:					
Corporate securities:					
Equity securities	\$1,360	\$14,649	\$—	\$—	\$16,009
Convertible securities	—	90,841	—	—	90,841
Fixed income securities	—	35,582	—	—	35,582
Municipal securities:					
Taxable securities	—	50,346	—	—	50,346
Tax-exempt securities	—	449,016	—	—	449,016
Short-term securities	—	113,056	719	—	113,775
Mortgage-backed securities	—	—	284	—	284
U.S. government agency securities	—	258,684	—	—	258,684
U.S. government securities	299	—	—	—	299
Derivative contracts	—	194,984	2,144	(178,161)	18,967
Total financial instruments and other inventory positions owned	1,659	1,207,158	3,147	(178,161)	1,033,803
Cash equivalents	1,896	—	—	—	1,896
Investments at fair value	39,953	—	121,637	(2)—	161,590
Total assets	\$43,508	\$1,207,158	\$124,784	\$(178,161)	\$1,197,289
Liabilities:					
Financial instruments and other inventory positions sold, but not yet purchased:					
Corporate securities:					
Equity securities	\$74,239	\$3,303	\$—	\$—	\$77,542
Fixed income securities	—	29,998	—	—	29,998
U.S. government agency securities	—	23,674	—	—	23,674
U.S. government securities	185,010	—	—	—	185,010
Derivative contracts	—	182,472	1,389	(179,616)	4,245
Total financial instruments and other inventory positions sold, but not yet purchased	\$259,249	\$239,447	\$1,389	\$(179,616)	\$320,469

(1) Represents cash collateral and the impact of netting on a counterparty basis. The Company had no securities posted as collateral to its counterparties.

(2) Noncontrolling interests of \$47.0 million are attributable to third party ownership in consolidated merchant banking and senior living funds.

Table of Contents

Piper Jaffray Companies

Notes to the Consolidated Financial Statements

(Unaudited)

The following table summarizes the valuation of the Company's financial instruments by pricing observability levels defined in ASC 820 as of December 31, 2017:

(Dollars in thousands)	Level I	Level II	Level III	Counterparty and Cash Collateral Netting (1)	Total
Assets:					
Financial instruments and other inventory positions owned:					
Corporate securities:					
Equity securities	\$1,863	\$ 50,033	\$ —	\$ —	\$ 51,896
Convertible securities	—	74,456	—	—	74,456
Fixed income securities	—	30,145	—	—	30,145
Municipal securities:					
Taxable securities	—	67,699	—	—	67,699
Tax-exempt securities	—	743,541	700	—	744,241
Short-term securities	—	61,537	714	—	62,251
Mortgage-backed securities	—	—	481	—	481
U.S. government agency securities	—	317,318	—	—	317,318
U.S. government securities	9,317	—	—	—	9,317
Derivative contracts	6	239,224	126	(213,783)	25,573
Total financial instruments and other inventory positions owned	11,186	1,583,953	2,021	(213,783)	1,383,377
Cash equivalents	3,782	—	—	—	3,782
Investments at fair value	39,504	—	126,060(2)	—	165,564
Total assets	\$54,472				