VALUE FOCUS

Asset Management Industry

SEGMENT FOCUS

Traditional Asset Managers

2017

Q1: Mutual Funds

Q2: Traditional Asset Managers

Q3: Alternative Asset Managers

Q4: Trust Banks

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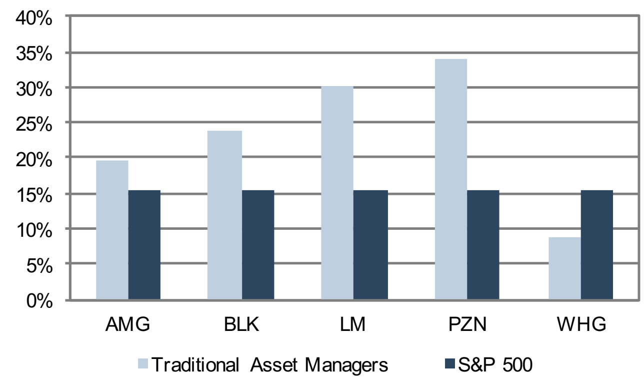
Segment Focus
Traditional Asset Managers

Most traditional asset managers are in bull market territory over the last year in the face of fee compression and continued outflows from active equity products. While hedge funds and PE firms tend to dominate the RIA headlines, traditional asset managers ("TAMs") are quietly gaining market share as investors question performance fees and the lack of transparency offered by many alternative asset managers. Indeed, all five components of our publicly traded TAM group in the chart to the right are up over the last year, and four of them have bested the market by a fairly considerable margin.

Share Price Performance

Twelve Months Ended June 30, 2017



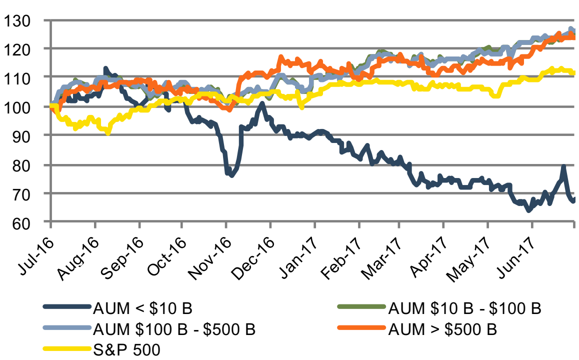
Source: SNL Financial

We attribute the group's gains to both systematic and non-systematic factors. That is, the market's gain (a systematic force affecting all stocks, especially RIAs) has clearly helped the group's collective AUM balance, while non-systematic forces such as solid investment performance (PZN), new account additions (BLK), and prior acquisitions (AMG/LM) account for much of the residual success of the individual components. In our experience, most well-established RIAs similarly attribute their success to systematic (market-related) and non-systematic (marketing-related) growth factors, and this group is no exception.

Market Overview
Second Quarter 2016

Asset Managers Index // Breakdown by Size

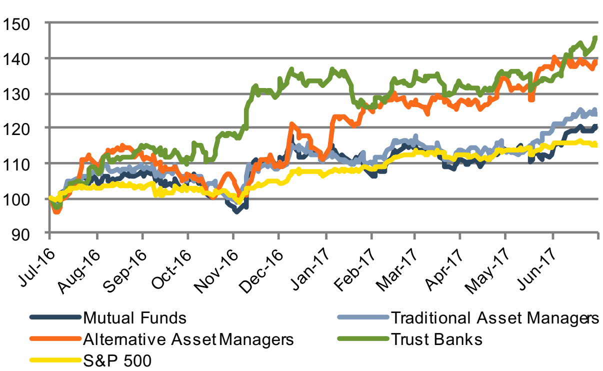
For the Twelve Months Ended June 30, 2017



Source: S&P Global Market Intelligence

Asset Managers Index // Breakdown by Type

For the Twelve Months Ended June 30, 2017



Source: S&P Global Market Intelligence

Market Overview
Second Quarter 2016

Favorable market conditions over the last twelve months have buoyed RIA market caps to all-time highs. This almost seems counter-intuitive against a backdrop of fee compression, fund outflows, and generally negative press (some of it by us), but a rising market means higher AUM balances, leading to greater fees and profitability, regardless of other headwinds facing the industry—not a perfect storm by any means, but good enough to outperform the broader indices during a relatively strong stock market rally.

Publicly traded custody banks (BNY Mellon, State Street, and Northern Trust) outperformed other classes of asset managers over the last twelve months, continuing their upward trajectory over the last few years but still lagging the broader indices since the financial crisis of 2008 and 2009. Placing this recent comeback in its historical context reveals the headwinds these businesses have been facing in a low interest rate environment that has significantly compressed money market fees and yields on fixed income investments. Their recent success may, therefore, be indicative of a reversion to mean valuation levels following years of depressed performance, rather than a sudden surge of investor optimism regarding future prospects. Further, pricing improvements for this group appear to be more relative to an improved banking environment than a change in circumstances for trust and custodial services.

Still, in recent quarters, most trust bank stocks outperformed other classes of asset managers, like mutual funds and traditional RIAs, as passive products and indexing strategies continued to gain ground on active management. A rising yield curve portends higher NIM spreads and reinvestment income, and the market has responded accordingly—our custody bank index gained 45% over the last year, surpassing the broader indices and all other classes of asset managers.

Publicly traded alternative asset managers have also performed well in recent months, but, like custody banks, are still reeling from poor investment returns over the last decade. The value-added proposition (alpha net of fees) has been virtually non-existent for many hedge funds and PE firms over this period despite the sector's recent gains.

Once again, the RIA size graph on page 1 seems to imply that smaller RIAs have significantly underperformed their larger peers over the last twelve months. The reality, though, is that this segment is the least diversified (only two components, Hennessy Advisors and US Global Investors, both of which are thinly traded) and certainly not a good representation of how RIAs with under $10 billion in AUM are actually performing. Specifically, Hennessy's weakness is largely attributable to recent sub-par investment performance from its Cornerstone Growth Fund, and US Global's focus on natural resource investing has taken a hit from softening commodity prices. Most of our clients fall under this size category, and we can definitively say that these businesses (in aggregate) haven't lost half their value since August as suggested by this graph. Other sizes of publicly traded asset managers have performed reasonably in line with the market over this period.

The outlook for these businesses is similarly market driven, though it does vary by sector. Trust banks are more susceptible to changes in interest rates and yield curve positioning. Alternative asset managers tend to be more idiosyncratic but still influenced by investor sentiment regarding their hard-to-value assets. Mutual funds and traditional asset managers are more vulnerable to trends in active and passive investing. All are off to a decent start in 2017 after a strong end to 2016 as the market weighs the impact of fee compression against rising equity prices.

M&A Review

We're perplexed by the lack of transactions in the RIA industry. A typical year reports less than a hundred deals in a space with almost 12,000 federally registered advisors. That means that less than 1% of the industry participants transact in a given year. How could that be in an aging profession with a highly scalable business model?

1. **Most RIAs are not big enough to be consistently profitable.** According to the Investment Adviser Association, the "typical" SEC-Registered Investment Adviser has $317 million in AUM, between 26 and 100 accounts, nine employees, and is headquartered in New York, California, Florida, Illinois, or Texas. It's hard to envision that a business of this size would generate enough revenue to cover overhead and professional staff expenses (likely in an expensive market) and yield much profitability, particularly during a market downturn. This is especially true if you consider that many believe $500 million in AUM to be the breakeven point for many asset managers to generate consistent levels of profitability (depending on size, headcount, location, client type, etc.). If valuation is based on earnings, then the average RIA does not have much to sell.

2. **Many asset managers don't have sustainable enterprise value beyond their owner(s).** A lot of RIA principals have not taken the necessary steps to transition their client relationships, investing acumen, business development capabilities, and/or managerial responsibilities to any other staffers or the next generation of firm leadership. To prospective buyers, this means there is significant risk that the RIA's viability will not outlive its owners. This is part of the reason why many asset manager deals are structured as earn-outs—to protect the buyer against future declines in fees or earnings associated with a principal's departure or reduced activity levels in the business.

3. **Asset managers are (currently) expensive.** Despite industry headwinds (fee pressure, competition from passive products, etc.), most public RIAs are more valuable than ever. Since the market is trading at an all-time high, many asset managers' AUM balances are as well, which means higher fees, earnings, and valuations. Such a high price tag makes them less appealing to buyers looking to maximize ROI.

4. **RIAs have distinct cultures that don't jive with prospective buyers.** This is the case with many industries but seems especially true for asset managers. The business and its reputation have come a long way from the *Wolf of Wall Street* broker culture. Still, these businesses tend to have unique attributes that aren't necessarily conducive to firms in different (or even the same) industries. For example, banks have taken an interest in the business for its high margins and low capital requirements. In our experience, bank and RIA cultures often don't mesh and can become an unforeseen hurdle in a deal.

5. **Asset managers value independence and often prefer to transition the business internally.** Most RIAs are employee-owned by design. To keep the company's culture and investment/client relations teams intact, principals considering retirement will often look to the next generation of firm leadership as prospective buyers for their interest. This avoids outside influence and appeases institutional investors who often seek independent RIAs wholly controlled by the firm's principals. Buy-sell or shareholders' agreements that allow younger principals to buy-in at a discount to fair market value are commonly a means to encourage employee ownership and independence.

On balance, though, we think the outlook for asset manager M&A is more promising. The industry is still fragmented and ripe for further consolidation. An aging ownership base and the recent market gains might induce prospective sellers to finally pull the trigger. Fee compression could also lead to more transactions if RIAs look to create synergies and cost efficiencies to maintain their profit margin. We haven't come across much of this yet but are seeing more clients and prospects ask about succession planning and exit strategies. Perhaps this is sign of more to come, which isn't saying much.

Asset Manager Multiples by Sector

				Pricing as of June 30, 2017			
	Ticker	6/30/2017 Stock Price	% of 52 Week High	Price / Trailing EPS	Price / Forward EPS	Total Capital / AUM (%)	Total Capital / EBITDA
TRADITIONAL ASSET MANAGERS							
Affiliated Managers Group, Inc.	AMG	165.86	96.75%	10.95	11.82	1.74	14.69
BlackRock, Inc.	BLK	422.41	98.04%	21.26	19.38	1.33	13.44
Legg Mason, Inc.	LM	38.16	93.48%	15.64	17.07	0.70	10.23
Pzena Investment Management, Inc.	PZN	10.16	87.89%	24.66	19.54	2.36	12.20
Westwood Holdings Group, Inc.	WHG	56.69	90.61%	18.09	nm	2.20	12.12
Group Median			**93.48%**	**18.09**	**18.23**	**1.74**	**12.20**
MUTUAL FUNDS							
AllianceBerstein Investments, Inc.	AB	23.65	98.75%	10.95	11.82	0.46	nm
Calamos Asset Management, Inc.	CLMS	8.28	93.35%	43.10	55.20	0.31	3.09
Cohen & Steers, Inc.	CNS	40.54	96.52%	19.71	20.49	2.93	11.10
INVESCO Ltd.	IVZ	35.19	97.99%	16.27	14.00	2.39	13.99
Franklin Resources, Inc.	BEN	44.79	98.22%	14.68	15.40	2.46	7.32
Diamond Hill Investment Group, Inc.	DHIL	199.40	92.92%	16.67	nm	3.31	7.92
Eaton Vance Corp.	EV	47.32	96.51%	21.58	18.74	nm	11.87
Hennessy Advisors, Inc,	HNNA	15.18	58.52%	7.88	nm	2.11	5.51
Manning & Napier, Inc.	MN	4.35	45.11%	7.50	9.29	nm	nm
T. Rowe Price Group, Inc.	TROW	74.21	96.17%	15.19	14.46	1.99	8.24
U.S. Global Investors, Inc.	GROW	1.52	66.46%	nm	nm	2.49	nm
Waddell & Reed Financial, Inc.	WDR	18.88	88.49%	9.61	11.83	1.44	4.74
Federated Investors, Inc.	FII	28.25	91.30%	13.85	14.08	0.82	8.15
Virtus Investment Partners, Inc.	VRTS	110.95	87.32%	16.30	15.51	2.07	13.21
Janus Capital Group Inc.	JNS	14.17	87.50%	15.52	14.59	1.36	7.88
Group Median			**92.92%**	**15.36**	**14.53**	**2.07**	**8.04**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, LLC	APO	26.45	93.07%	9.54	10.22	3.25	4.35
Brookfield Asset Management, Inc.	BAM.A	39.21	97.80%	25.95	19.36	44.52	16.37
Blackstone Group L.P.	BX	33.35	98.29%	17.25	11.47	13.06	14.11
Carlye Group, L.P.	CG	19.75	99.00%	20.00	7.83	3.49	6.39
Fortress Investment Group LLC	FIG	7.99	99.38%	41.59	7.95	4.19	10.87
Kohlberg Kravis Roberts & Co.	KKR	18.60	91.45%	10.39	8.22	19.24	nm
Oaktree Capital Group, LLC	OAK	46.60	97.18%	13.24	12.59	10.86	nm
Och-Ziff Capital Mgmt Group LLC	OZM	2.56	54.17%	nm	6.11	3.21	nm
Group Median			**97.49%**	**17.25**	**9.22**	**7.53**	**10.87**
TRUST BANKS							
Northern Trust Corporation	NTRS	97.21	98.47%	22.26	20.11	nm	nm
Bank of New York Mellon Corporation	BK	51.02	98.90%	15.64	14.61	0.54	nm
State Street Corporation	STT	89.73	98.14%	16.02	15.16	nm	nm
Group Median			**98.47%**	**16.02**	**15.16**	**nm**	**nm**
OVERALL MEDIAN			**96.17%**	**16.02**	**14.46**	**2.36**	**10.55**

MERCER CAPITAL

5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137

In This Issue

About Value Focus Asset Management Industry

Mercer Capital's Value Focus is a quarterly publication providing perspective on valuation issues pertinent to asset managers, trust companies, and investment consultants. Each issue highlights a market segment: 1st quarter: Mutual Fund Companies, 2nd quarter: Traditional Asset Managers, 3rd quarter: Alternative Asset Managers, and 4th quarter: Trust Banks. View past issues at www.mercercapital.com.

About Mercer Capital

As one of the largest valuation firms in the United States, Mercer Capital provides asset managers, trust companies, and investment consultants with corporate valuation, financial reporting valuation, transaction advisory, portfolio valuation, and related services.

Matt Crow, ASA, CFA
President
901.322.9728
crowm@mercercapital.com

Brooks Hamner, CFA
Vice President
901.322.9714
hamnerb@mercercapital.com

www.mercercapital.com

Mercer Capital is a business valuation and financial advisory firm serving a global client base. Business valuation services are provided for a wide variety of needs, including but not limited to corporate valuation services, tax compliance, litigation support, financial statement reporting compliance, and employee stock ownership plans. Our clients range from public to private, from smaller companies to large multi-nationals in a broad range of industries, as well as numerous governmental agencies. In addition, Mercer Capital provides investment banking and corporate advisory services including sell-side and buy-side merger & acquisition representation, fairness opinions, solvency opinions, business interest and securities valuation, among others.