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SEGMENT FOCUS

Alternative Asset Managers

2016

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Segment Focus
Alternative Asset Managers

Just a few weeks ago, the largest publicly traded hedge fund, Och-Ziff Capital Management Group, agreed to pay $413 million to settle federal charges that it disbursed more than $100 million in bribes to African government officials. Even before this announcement, the hedge fund industry was in quite the slump. Since June of last year, publicly traded hedge funds and PE firms have lost 40% of their market cap. We've discussed the **many headwinds facing this industry on our blog**, but generally speaking, investors are simply fed up with the low return, high fee combination that has recently characterized the industry, particularly over the last year and a half. The Fed's anti-volatility campaign hasn't helped matters, and isn't likely to abate any time soon.

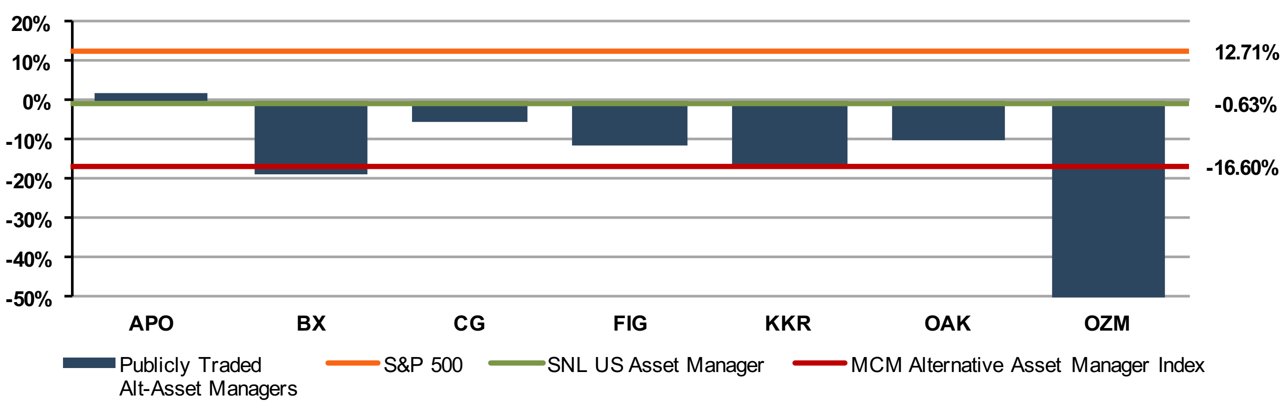
The Och-Ziff scandal reveals another potential headwind that isn't necessarily company-specific. While difficult to measure, reputational risk is very real for these businesses that rely heavily on investor trust, transparency, and overall status within the financial community to raise capital. FIFA-like scandals are unacceptable to institutional investors already wary of high fees and sub-par performance.

With this as a backdrop, it is hard to envision much of a silver lining. Still, as we've noted in the post "**Performance Fees are Dead! Long Live Performance Fees!**" asset bubbles are relative. With a third of the developed world selling bonds at negative yields, and the U.S. stock market trending up after six straight quarters of earnings declines, bidding for any return at all in the private company space looks, at least on a relative basis, attractive. Fund raising is still alive and well in alt assets, and should be for some time to come.

The old 2 and 20 management fee / carry model, however, is on life support and probably not going to make it – at least not as the industry standard. The few PE firms and hedge funds still capable of charging such high rates are consistently in the top 5% of investment performance, and sustaining that level of alpha over the long term is nearly impossible. One and ten over a predetermined hurdle is the new normal, and even that could come under pressure if performance continues to suffer while fees tighten for other classes of asset managers.

Share Price Performance

Twelve Months Ended September 30, 2016



Source: S&P Global Market Intelligence

Market Overview
Third Quarter 2016

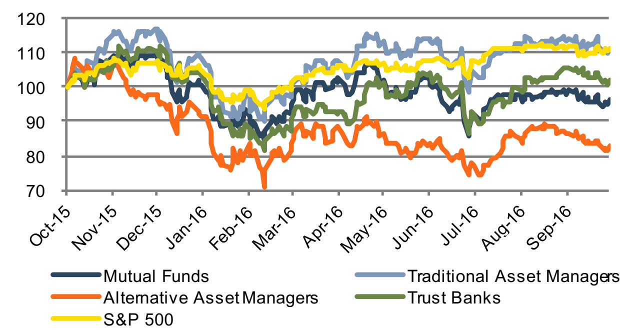
The past few months have been promising for most publicly traded RIAs. Relatively stable market conditions and better than expected earnings are the likely culprits for the group's "comeback," which has the overall index up 13% since February.

Nevertheless, all classes of asset managers have underperformed the broader market over the last year, with hedge funds and PE firms leading the descent. **We've discussed this sector's plight ad nauseam**, and it shouldn't be surprising that the most expensive asset class with the worst overall performance would continue to be shunned by investors – both on an absolute and relative basis.

Further, there hasn't been much in the way of multiple relief as valuations are flat to down for most categories of asset managers in 2016. The cost of capital remains subdued (or subjugated, depending on your perspective), so the market seems to be anticipating lower growth prospects for the sector as a whole. Fee pressure, regulatory overhang, and index investing are all to blame and will likely remain a headwind to the sector for the foreseeable future.

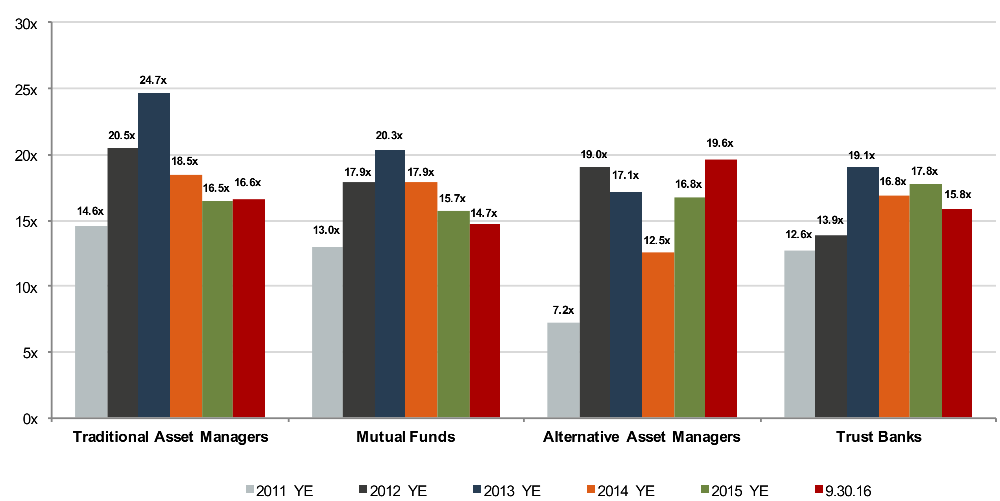
So why the recent uptick in pricing? Is this truly evidence of a comeback or is this simply mean reversion? If prices (P) are generally up over the last few months, and P/E ratios are flat to declining, then that would suggest earnings (E) are actually rising for most of these businesses. We'll see how Q3 fared, but **recent earnings calls** have focused on market volatility and the threats and opportunities inherent in the trend towards passive investing. Meanwhile, the markets have stabilized (for the most part) and drifted upward since February, likely buoying AUM, management fees, and earnings over the last two quarters.

All Types of Asset Managers Underpreformed the S&P 500 Over the Last Year



Source: S&P Global Market Intelligence

Historical Median Price / LTM EPS by Sector



M&A Review
Third Quarter 2016

The recent **Pathstone-Convergent deal** and **Focus Financial IPO** has shown how resilient RIA deal-making can be **despite the greatly diminished growth prospects** for the industry as a whole. Other recent deals include:

- On August 30th, Harwood Wealth Management announced the acquisition of Network Direct Ltd. for £4 million up front and a potential £3 million in earn-out consideration contingent upon Harwood's ability to convert Network's client assets into Harwood AUM over a five-year period.
- FAB Partners, an alternative investment platform, announced the acquisition of $14 billion private debt manager, CIFC LLC on August 19th for $333 million or 2.4% of AUM and a 60% premium over CIFC's closing price the day before. Though 2.4% of AUM appears low for a strategic acquisition of an alt asset manager, a quick look to CIFC's public filings reveals significant declines in revenue and profitability from 2014 to 2015 before ticking back up in the first half of this year.
- On August 24th, hedge fund manager Emerging Sovereign Group announced that its management team would buy back the 55% ownership stake it sold in 2011 to PE giant, Carlyle Group. Although deal terms were not disclosed, AUM grew from $1.25 billion to $3.5 billion over this time, so it is probably safe to assume that Carlyle achieved a high IRR on this one.

Indeed, **mutual fund outflows** and **multiple contraction** seems to actually have positive implications for sector M&A in 2016. The maturation of the mutual fund industry and active equity managers will likely spur consolidation and buying opportunities for those looking to add scale. With valuations and market caps down over the last two years, the affordability index has gotten a lot better for many of these businesses.

Expectations for slower growth (reflected in lower multiples) could be another driver of deal-making, as RIAs look to other asset managers to build or replace AUM depleted by outflows and market movements. If organic growth opportunities are truly stalling, acquisitions are a viable means to offset falling management fees and collect market share for those that can afford to do so.

On balance, 2016 could be a record year for asset manager transactions both in terms of deal count and collective volume. While this may be a stretch given the number of distressed sales during the financial crisis, a continuation of the current trend is certainly achievable.

Asset Manager Multiples by Sector

	Ticker	9/30/2016 Stock Price	% of 52 Week High	Pricing as of September 30, 2016 Price / Trailing EPS	Price / Forward EPS	Total Capital / AUM	Total Capital / EBITDA
TRADITIONAL ASSET MANAGERS							
Affiliated Managers Group, Inc.	AMG	144.55	75.78%	11.77	13.10	1.69%	11.72
BlackRock, Inc.	BLK	365.97	97.38%	19.58	19.06	1.32%	12.56
Legg Mason, Inc.	LM	33.68	73.86%	13.11	10.04	0.77%	78.06
Pzena Investment Management, Inc.	PZN	7.79	81.72%	16.62	19.97	2.07%	10.60
Westwood Holdings Group, Inc.	WHG	50.93	85.37%	18.60	nm	2.15%	11.57
Group Median			**81.72%**	**16.62**	**16.08**	**1.69%**	**11.72**
MUTUAL FUNDS							
AllianceBerstein Investments, Inc.	AB	22.71	88.01%	11.77	13.10	0.45%	nm
Calamos Asset Management, Inc.	CLMS	6.84	71.21%	nm	207.27	0.80%	1.96
Cohen & Steers, Inc.	CNS	41.55	95.38%	25.53	21.72	3.24%	14.93
GAMCO Investors, Inc.	GBL	28.79	69.17%	8.88	7.72	2.88%	7.07
INVESCO Ltd.	IVZ	30.18	88.77%	13.99	13.42	2.31%	12.56
Franklin Resources, Inc.	BEN	35.10	84.41%	13.23	12.59	3.06%	5.29
Diamond Hill Investment Group, Inc.	DHIL	181.00	78.07%	16.15	nm	3.56%	9.35
Eaton Vance Corp.	EV	38.33	94.97%	20.00	17.94	1.58%	10.93
Hennessy Advisors, Inc,	HNNA	36.16	91.74%	13.49	nm	3.39%	8.43
Manning & Napier, Inc.	MN	7.18	70.46%	9.84	10.16	0.41%	0.28
T. Rowe Price Group, Inc.	TROW	67.02	86.15%	15.53	15.90	2.14%	8.85
U.S. Global Investors, Inc.	GROW	1.96	84.44%	nm	nm	3.38%	nm
Waddell & Reed Financial, Inc.	WDR	17.91	49.21%	7.66	8.75	1.94%	3.17
Federated Investors, Inc.	FII	31.82	96.05%	17.26	16.09	0.95%	10.04
Virtus Investment Partners, Inc.	VRTS	92.56	66.29%	19.85	17.70	2.29%	12.88
Janus Capital Group Inc.	JNS	13.85	88.25%	15.45	15.92	1.54%	7.62
Group Median			**85.29%**	**14.72**	**15.90**	**2.22%**	**8.64**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, LLC	APO	17.96	94.50%	17.8x	11.0x	2.94%	8.7x
Brookfield Asset Management, Inc.	BAM.A	32.83	92.50%	21.4x	35.3x	2.94%	17.0x
Blackstone Group L.P.	BX	25.76	77.43%	100.2x	12.1x	10.47%	37.6x
Carlye Group, L.P,	CG	15.69	82.30%	nm	11.6x	3.66%	12.1x
Fortress Investment Group LLC	FIG	5.09	88.40%	16.6x	5.5x	3.17%	9.4x
Kohlberg Kravis Roberts & Co.	KKR	14.35	76.89%	nm	26.3x	18.93%	nm
Oaktree Capital Group, LLC	OAK	43.78	86.93%	29.3x	17.7x	10.58%	nm
Och-Ziff Capital Mgmt Group LLC	OZM	4.04	41.16%	6.0x	nm	5.95%	nm
Group Median			**84.62%**	**19.6x**	**12.1x**	**4.80%**	**12.1x**
TRUST BANKS							
Northern Trust Corporation	NTRS	68.36	91.68%	17.13	16.12	nm	nm
Bank of New York Mellon Corporation	BK	40.06	90.80%	13.65	13.22	nm	nm
State Street Corporation	STT	69.29	93.52%	13.77	13.77	nm	nm
Group Median			**91.68%**	**13.77**	**13.77**	**nm**	**nm**
OVERALL MEDIAN			**85.76%**	**15.84**	**13.77**	**2.31%**	**10.32**

Data Source: S&P Global Market Intelligence

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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.

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