MERCER CAPITAL

VALUE FOCUS

# Asset Management Industry

SEGMENT FOCUS

## Wealth Managers

## 2018


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Q1: Asset Managers

Q2: Wealth Managers

Q3: Alternative Asset Managers

Q4: Trust Banks

# Segment Focus: Wealth Managers
## Opportunities Abound Despite Headwinds

Wealth management firms have fared well in recent years on the back of rising markets, but the underlying drivers suggest an industry in flux – global investible assets are at all-time highs, intergenerational wealth transfer is accelerating, and fintech products are poised to disrupt. And yet, many analysts are skeptical about the industry's prospects. Rising global wealth means that there are more assets for wealth managers to manage, and intergenerational wealth transfer means that there are also more opportunities to gain (and lose) clients. Fintech products threaten competition, but also offer efficiencies for agile firms. Depending on your point of view, the industry is either poised to grow or on the verge of massive disruption.

One thing is clear: the wealth management industry has benefited from the fact that global wealth – and demand for wealth management services – is at all-time highs. According to Capgemini's 2018 **World Wealth Report**, global wealth held by high net worth (HNW) individuals grew 10.6% to more than $70 trillion in 2017. More wealth means, well, more wealth to manage, and revenue at wealth management firms has generally increased with the market. But for wealth managers, business is also a function of who holds that wealth – and that is changing. As baby boomers continue to retire over the next decade, trillions of dollars of wealth will be transferred to a younger generation. This massive wealth churn is an opportunity for wealth management firms to attract a new, younger client base, but wealth managers face several challenges in appealing to that new demographic.

One such challenge is the industry's aging advisor base. **According to data from EY**, the average advisor is now 50 years old, and only 5% of advisors are under 30. As assets move from one generation to the next, a weak pipeline of new advisors is a looming threat for the industry. The age gap between clients and their advisors is poised to create real difficulties in attracting and retaining an evolving client demographic, particularly given the increasing prominence of fintech-based competition. A lack of succession planning at many wealth management firms will only exacerbate these problems.

With a changing client demographic also comes changing expectations, and wealth management firms face pressure to adapt their service and product offerings as a result – most notably through changing the way that they utilize technology. On its face, fintech-based wealth management products appear to be a threat to traditional human advisors, and less agile firms will likely find this to be true. But for other firms, fintech-based solutions offer an opportunity to increase advisor efficiency and meet regulatory requirements by utilizing hybrid advice models. By utilizing fintech solutions, wealth management firms can free up advisors from routine tasks and allow advisors to offer a greater breadth of client services and improve client relationships.

### Stay Up-to-Date with Our RIA Valuation Insights Blog

Updated weekly, Mercer Capital's Asset Management team addresses issues important to the wealth management industry on our ***RIA Valuation Insights*** blog.

Focus Financial's recent IPO has dominated much of the industry's recent headlines. We offer our take on its pricing levels in the post "**Now That Focus Has Priced – Is It Pricey?**"

Focus' strategy naturally raises questions on succession planning and consolidation as noted in this newsletter and our post "**Does the Money Management Industry Need Consolidation?**"

Learn more about the blog and subscribe for future updates at **mercercapital.com/riavaluationinsights**.

Despite its potential benefits, technology is also partly responsible for the continued fee pressure wealth managers face. **According to data from McKinsey & Company**, pricing on fee-based accounts dropped by five basis points to 1.08% in 2017. Establishing a personal connection with clients is one way wealth management firms can differentiate themselves to help maintain pricing power. **According to a 2018 study by Capgemini**, only 56% of HNW individuals said they connected strongly with their advisor. This low satisfaction comes despite the strong market returns over the last two years, which suggests that performance is not the only concern of wealth management clients.

The current fee-conscious environment favors advisors that offer a value proposition that software cannot replicate at a lower cost. And ultimately, such a value proposition will likely need to be based on establishing real relationships with clients. Growing revenue on the back of strong markets may have masked the changes in the business for many wealth management firms, and the party may end if equity markets normalize going forward. One thing the industry has going for it is that the demand for wealth management services is clearly there – and increasingly so. The performance of wealth management firms will depend in large part on how well individual firms are able to adapt to an evolving landscape to capture growing demand.

# Market Overview

## RIA Stocks Post Mixed Performance During Second Quarter

Over the last several years, asset managers have benefited from global increases in financial wealth driven by a bull market in asset prices. But favorable trends in asset prices have masked some of the headwinds the industry faces, including increasing consumer skepticism of high-fee active products and regulatory overhang.

Traditional active managers have felt these pressures most acutely, as undifferentiated active products have struggled to withstand downward fee pressure and at the same time have been a major target of regulatory developments. To combat fee pressure, traditional asset managers have had to either pursue scale (e.g. BlackRock) or offer products that are truly differentiated (something that is difficult to do with scale). Consumers have been more receptive to the value proposition of alternative asset managers and wealth managers, and these businesses are better positioned to withstand fee pressure as a result.

Perhaps reflective of the headwinds that the industry faces, asset managers generally underperformed broad market indices during the second quarter. While major indices regained traction during the second quarter, the returns for asset managers were generally more muted even though these businesses generally benefit from rising markets. The operating leverage inherent in the business model of most asset managers suggests that market movements tend to have an amplified effect on the profitability (and stock prices) of these businesses, and in recent quarters that has been the case. The reversal of that trend last quarter may be indicative of investors' increasing focus on the headwinds the industry faces and the general uncertainty that arises late in the economic cycle.

Taking a closer look at recent pricing reveals that traditional asset managers, which are perhaps the most affected by fee compression trends, ended the quarter down 3.7%, while other categories of asset managers generally saw positive returns during the quarter. Trust banks were up 2.4% during the quarter, buoyed by a steadily rising yield curve which portends higher NIM spreads and reinvestment income. Alternative asset managers were up 2.8% during the quarter as this product segment is less impacted by fee pressure

**Chart 3: Asset Manager Performance by Sector**

Second Quarter 2018

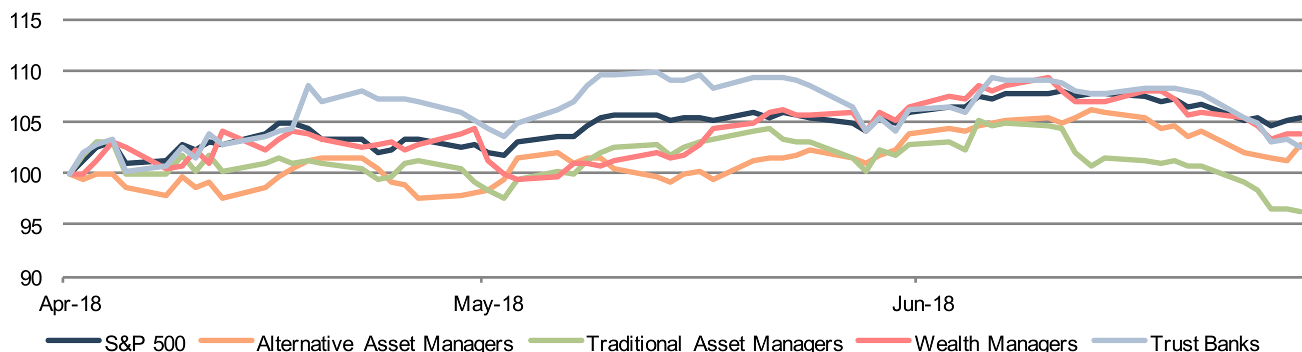
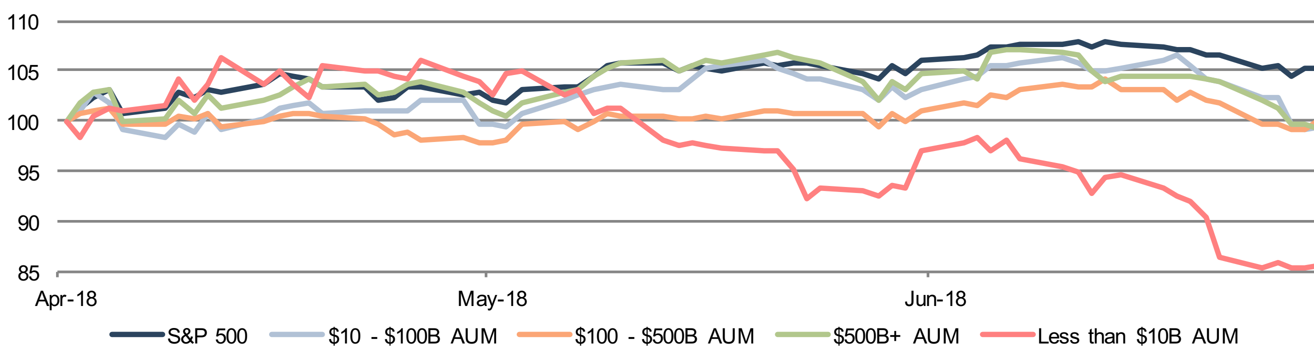



**Chart 4: Asset Manager Performance by Size**

Second Quarter 2018




than traditional active products. Wealth managers were up 3.8% during the quarter, buoyed by market-driven increases in AUM, although these businesses face challenges with new client acquisition and maintaining pricing power.

The RIA size graph shows a similar trend for most of its categories. The smallest category of publicly traded RIAs (those with less than $10 billion AUM) was down nearly 15% during the quarter, although this is the least diversified category of RIAs with only two components. Due to the lack of diversification, the smallest category of RIAs is subject to a high degree of volatility due to company-specific developments. Most of our clients fall under this size category, and we can definitively say that these businesses (in aggregate) have not lost nearly 15% of their value since April as suggested by this graph.

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# Asset Manager M&A Activity Continues to Accelerate in 2018

Asset manager M&A was robust through the first two quarters of 2018 against a backdrop of volatile market conditions. Total deal count during the first half of 2018 increased 60% versus the same period during 2017, and total disclosed deal value was up nearly as much. In terms of deal volume, M&A is on pace to reach the highest levels since 2009, although we note that the quarterly data can be lumpy. Several trends which have driven the uptick in sector M&A have continued into 2018, including revenue and cost pressures, RIA aggregators, and an increasing interest from bank acquirers.

The underpinnings of the M&A trend we've seen in the sector include increasing compliance and technology costs, broadly declining fees, aging shareholder bases, and slowing organic growth for many active managers. While these pressures have been compressing margins for years, sector M&A has historically been muted, due in part to challenges specific to asset manager combinations, including the risks of cultural incompatibility and size impeding alpha generation. Nevertheless, the industry structure has a high degree of operating leverage, which suggests that scale could alleviate margin pressure as long as it doesn't inhibit performance.

> *"Since I've been in the industry, there's been declarations of massive consolidation. I do think though, this time there are a set of factors in place that weren't in place before, where scale does matter, largely driven by the cost coming out of the regulatory environments and the low rate environments in cyber and alike. And, you have to be, as a firm, you have to be able to invest in the future. And I think a number of smaller-sized firms are finding that hard."*
>
> *Martin Flanagan - President and CEO, Invesco Ltd.*
> *1Q17 Earnings Call*

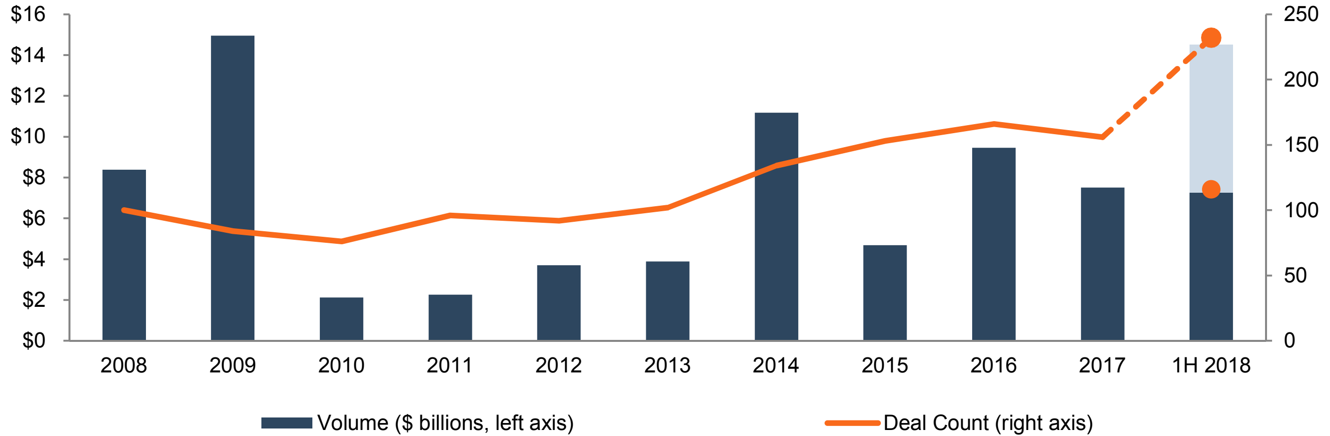
> *"You need to have, of course, the right product set. But you need especially to have underlying firms, which are positioned as best they can in terms of alignment and focus to sustain alpha generation. And in that respect, scale is the enemy, not the friend."*
>
> *Sean Healey, Affiliated Managers Group Inc*
> *1Q17 Earnings Call*

Consolidation pressures in the industry are largely the result of secular trends. On the revenue side, realized fees continue to decrease as funds flow from active to passive. On the cost side, an evolving regulatory environment threatens increasing technology and compliance costs. Over the past several years, these consolidation rationales have led to a significant uptick in the number of transactions as firms seek to realize economies of scale, enhance product offerings, and gain distribution leverage.

Acquisition activity in the sector has been led primarily by RIA consolidators, with Focus Financial Partners (which **submitted IPO filings** this May), Mercer Advisors (no relation), and United Capital Advisors each acquiring multiple RIAs over the last year. While these serial acquirers account for most of the M&A activity in the sector, banks have also been increasingly active acquirers of RIAs in their hunt for returns not tied to interest rate movements. Despite a rising yield curve and the negative impact of goodwill on tangible book value, we suspect that RIAs will remain attractive targets for bank acquirers due to the high margins (relative to many other financial services businesses), low capital requirements, and cross-selling opportunities.

Recent increases in M&A activity come against a backdrop of a bull market in asset prices that has continued through the second quarter of 2018. Steady market gains have more than

**Asset Manager M&A** (2008 – Q2 2018)




*Source: Bloomberg*
*Transactions involving US-based targets and buyers*

offset the consistent and significant negative AUM outflows that many active managers have seen over the past several years. In 2016, for example, active mutual funds' assets grew to $11 trillion from $10.7 trillion, despite $400 billion in net outflows according to data from Bloomberg. Because of increasing AUM and concomitant revenue growth, profitability has trended upwards despite industry headwinds that seem to rationalize consolidation.

With no end in sight for the consolidation pressures facing the industry, asset manager M&A appears positioned for continued strength or potential acceleration regardless of which way the markets move during the rest of 2018. Given the uncertainty of asset flows in the sector, we expect firms to continue to seek bolt-on acquisitions that offer scale and known cost savings from back office efficiencies. Expanding distribution footprints and product offerings will also continue to be a key acquisition rationale as firms have struggled with organic growth. With over 11,000 RIAs currently operating in the U.S., the industry is still very fragmented and ripe for consolidation. An aging ownership base is another impetus, and recent market gains might induce prospective sellers to finally pull the trigger. More broadly, the recent tax reform bill is expected to free up foreign-held cash and increase earnings, which could further facilitate M&A's upward trend during the rest of 2018.

### Asset Manager Multiples by Sector

| | | | | Pricing as of June 30, 2018 | | | |
|---|---|---|---|---|---|---|---|
| | Ticker | 6/30/2018 Stock Price | % of 52 Week High | Price / Trailing EPS | Price / Forward EPS | Enterprise Value / AUM (%) | Enterprise Value / EBITDA |
| **TRADITIONAL ASSET MANAGERS** | | | | | | | |
| Affiliated Managers Group, Inc. | AMG | $148.67 | 68.7% | 11.0x | 10.8x | 1.39 | 11.9x |
| BlackRock, Inc. | BLK | 499.04 | 84.8% | 21.1x | 18.0x | 1.32 | 13.6x |
| Legg Mason, Inc. | LM | 34.73 | 74.9% | 12.4x | 10.3x | 0.61 | 11.5x |
| Pzena Investment Management, Inc. | PZN | 9.21 | 73.1% | -8.3x | 11.7x | 1.71 | 7.7x |
| Westwood Holdings Group, Inc. | WHG | 59.54 | 86.2% | 18.3x | nm | 2.15 | 12.3x |
| **Group Median** | | | **74.9%** | **12.4x** | **11.2x** | **1.39** | **11.9x** |
| **MUTUAL FUNDS** | | | | | | | |
| AllianceBerstein Investments, Inc. | AB | $28.55 | 95.8% | 11.0x | 10.8x | 0.52 | nm |
| Cohen & Steers, Inc. | CNS | 41.71 | 88.7% | 17.6x | 17.0x | 3.00 | 10.7x |
| INVESCO Ltd. | IVZ | 26.56 | 70.5% | 11.2x | 9.8x | 1.24 | 7.0x |
| Franklin Resources, Inc. | BEN | 32.05 | 74.8% | 9.9x | 11.2x | 1.31 | 4.0x |
| Diamond Hill Investment Group, Inc. | DHIL | 194.43 | 89.6% | 15.1x | nm | 2.92 | 7.9x |
| Eaton Vance Corp. | EV | 52.19 | 86.6% | 17.8x | 16.3x | nm | 11.3x |
| Hennessy Advisors, Inc, | HNNA | 17.35 | 87.2% | 8.4x | nm | 2.18 | 5.7x |
| Manning & Napier, Inc. | MN | 3.10 | 72.9% | 2.4x | 14.4x | nm | nm |
| T. Rowe Price Group, Inc. | TROW | 116.09 | 91.6% | 18.4x | 15.8x | 2.79 | 11.6x |
| U.S. Global Investors, Inc. | GROW | 1.61 | 21.6% | 42.5x | nm | 2.80 | nm |
| Waddell & Reed Financial, Inc. | WDR | 17.97 | 76.4% | 10.4x | 8.3x | 1.75 | 5.7x |
| Federated Investors, Inc. | FII | 23.32 | 64.6% | 10.4x | 10.4x | 0.59 | 6.1x |
| Virtus Investment Partners, Inc. | VRTS | 127.95 | 92.7% | 17.0x | 10.3x | 1.59 | 8.8x |
| **Group Median** | | | **86.6%** | **11.2x** | **11.0x** | **1.75** | **7.4x** |
| **ALTERNATIVE ASSET MANAGERS** | | | | | | | |
| Apollo Global Management, LLC | APO | $31.87 | 88.1% | 72.4x | 21.5x | 3.46 | 8.4x |
| Blackstone Group L.P. | BX | 32.17 | 88.9% | nm | 10.5x | 11.35 | 12.3x |
| Carlyle Group, L.P, | CG | 21.30 | 84.4% | 9.2x | 8.6x | 4.11 | 6.0x |
| Kohlberg Kravis Roberts & Co. | KKR | 24.85 | 99.0% | 15.3x | 15.4x | 20.20 | nm |
| Oaktree Capital Group, LLC | OAK | 40.65 | 89.4% | 10.1x | 14.5x | 9.37 | 11.2x |
| Och-Ziff Capital Mgmt Group LLC | OZM | 1.93 | 51.1% | 1.7x | 5.3x | 2.97 | 3.5x |
| **Group Median** | | | **88.5%** | **10.1x** | **12.5x** | **6.74** | **8.4x** |
| **TRUST BANKS** | | | | | | | |
| Northern Trust Corporation | NTRS | $102.89 | 93.2% | 19.2x | 15.5x | nm | nm |
| Bank of New York Mellon Corporation | BK | 53.93 | 92.2% | 14.6x | 12.9x | nm | nm |
| State Street Corporation | STT | 93.09 | 82.2% | 13.6x | 12.3x | nm | nm |
| **Group Median** | | | **92.2%** | **14.6x** | **12.9x** | **nm** | **nm** |
| **OVERALL MEDIAN** | | | **86.2%** | **13.0x** | **11.7x** | **2.16** | **8.6x** |

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Data Source: S&P Global Market Intelligence

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## About Value Focus Asset Management Industry

Mercer Capital's Value Focus is a quarterly publication providing perspective on valuation issues pertinent to asset managers, wealth managers, trust companies, and investment consultants. Each issue highlights a market segment: 1st quarter: Asset Managers, 2nd quarter: Wealth 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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