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Asset Management Industry

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Alternative Asset Managers

2018

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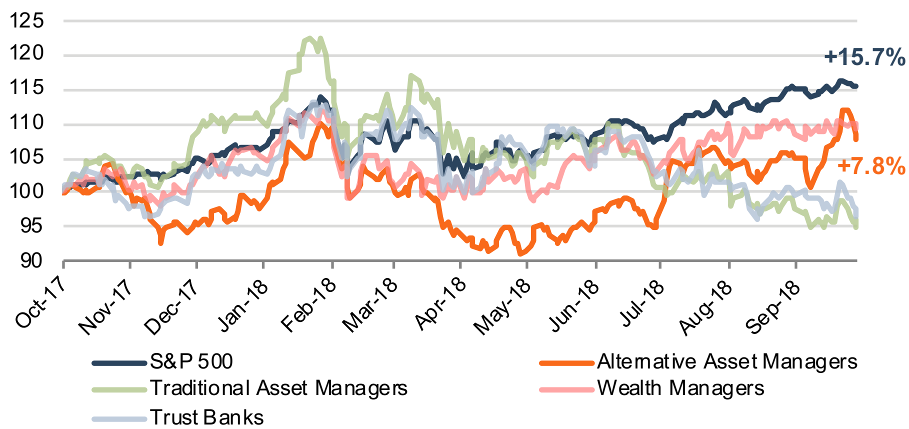
Alternative Asset Managers
Opportunities Abound Despite Headwinds

Alternative Asset Manager Index Performance

LTM September 30, 2018



Source: S&P Global Market Intelligence

Alternative investment managers took off in the wake of the financial crisis when investors flocked to risk mitigating strategies and uncorrelated asset classes, but during 2015 and 2016, these businesses floundered against a backdrop of strong equity market performance. Alt managers bounced back in 2017, and over the last twelve months they have continued to perform well, although there have been volatile swings during the year. Despite improving performance over the last two years, the industry continues to face a number of headwinds, including fee pressure, expanding index opportunities, and relative underperformance.

Hedge fund managers in particular have struggled since the financial crisis. Although industry assets reached a record $3.2 trillion in 2018, net inflows have stagnated and the record AUM level is primarily due to market increases rather than investor interest in the asset class. At the same time, the industry is struggling with fee schedules that continue to decline and a plummeting number of new funds being established.[1]

And yet the alternative asset management sector as a whole has endured and performed reasonably well over the last year, at least in the eyes of market participants. While performance has been volatile, alt managers closed out the year ended September 30 up 7.8%—making them one of the better performing sectors of publicly traded asset managers over the past year. For all the problems the industry faces, most investors still value the diversification offered by alternative assets, particularly late in the economic cycle. And while active management may not be as lucrative as it once was, it is still sought by many institutional investors to complement their passive holdings.

Given performance over the last year, the market appears to be reasonably optimistic about the prospects for most publicly traded alt managers, at least relative to other categories of asset managers. Some of the fundamentals are improving as well. Asset flows out of active products seem to have stabilized, and AUM growth has generally been outpacing fee compression in recent quarters. We think performance fees will likely continue to fall (in one form or another), but, like active management, never be totally eliminated. So on balance, a modestly improving outlook for the industry appears justified.

[1] "The Incredible Shrinking Hedge Fund," *Bloomberg*.

Market Overview

RIA Stocks Post Mixed Performance During Third Quarter

During the recent market cycle, investment management firms have benefited from global increases in financial wealth driven by a bull market in most asset prices. These favorable trends in asset prices have masked some of the headwinds the industry faces, however, including growing consumer skepticism of higher-fee products and regulatory overhang.

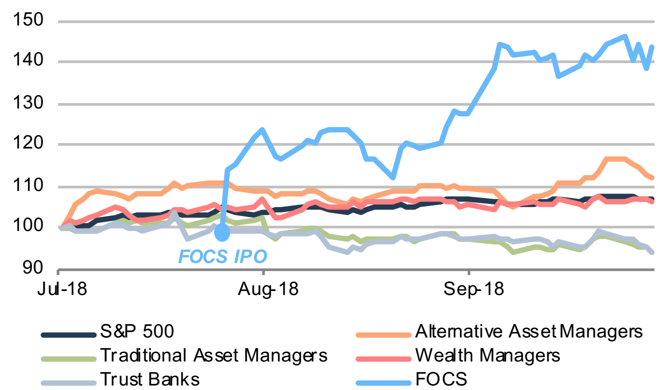
Traditional active managers have felt these pressures most acutely, as poorly differentiated active products struggled to withstand downward fee velocity and at the same time have been a prime target of regulatory developments. To combat fee pressure, traditional asset managers have had to either pursue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

Reflective of the headwinds that the industry faces, asset managers generally underperformed broad market indices during the third quarter. While major indices posted solid gains during the second quarter, the returns for asset managers were at best muted, even though these businesses generally benefit from rising equity 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 over the last two quarters may be indicative of investors' increasing concerns about the headwinds the industry faces and the general uncertainty that arises late in the economic/market cycle.

While wealth managers performed well during the quarter, they were outpaced by wealth management firm aggregator Focus Financial Partners ("FOCS"), which closed out the quarter up 44% since its noteworthy IPO in late July. FOCS, of course, is not an RIA—but since FOCS is an aggregation of RIA cash flows, some comparison between FOCS and RIAs is inevitable. FOCS is not necessarily a proxy for the performance of RIAs, since the success of the FOCS business model depends on more than just the performance of its partner firms. This is particularly true now as FOCS is growing rapidly and investors are arguably more attuned to FOCS's ability to string together acquisitions at attractive deal terms than on the performance of the partner firms post-acquisition. Over time FOCS's performance should bear some resemblance to that of the underlying partner firms, but right now the performance of FOCS might not be telling us much other than affirming the market's conviction that it will continue to grow rapidly through acquisitions.

Asset Manager Performance by Sector

Third Quarter 2018



Source: S&P Global Market Intelligence

The outlook for these businesses is 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. Wealth managers and traditional asset managers are more vulnerable to trends in active and passive investing. The outlook for the industry during the rest of 2018 ultimately depends on how the industry headwinds continue to evolve and what the market does during the fourth quarter, which has been highly volatile so far.

Asset Manager M&A Trends

Deal Activity Continues to Accelerate Through the Third Quarter

Asset manager M&A was robust through the first three quarters of 2018 against a backdrop of volatile market conditions. Several trends which have driven the uptick in sector M&A in recent years have continued into 2018, including increasing activity by RIA aggregators and rising cost pressures. Total deal count during the first three quarters of 2018 increased 45% versus the same period in 2017 and total disclosed deal value was up over 150%. In terms of both deal volume and deal count, M&A is on pace to reach the highest levels since 2009.

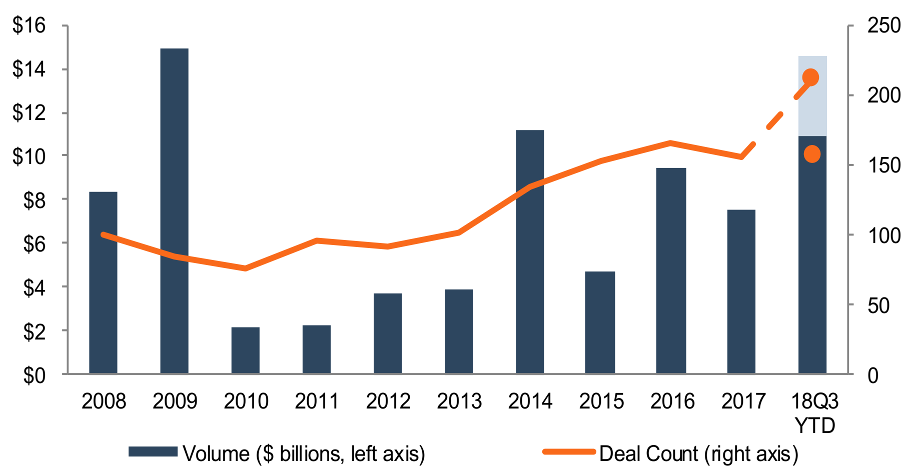
And so far in the fourth quarter, M&A shows no signs of slowing down. A few weeks ago, Invesco Ltd. (IVZ) announced plans to acquire the OppenheimerFunds unit from MassMutual for $5.7 billion in one of the largest sector deals over the last decade. IVZ will tack on $250 billion in AUM as a result of the deal, pushing total AUM to $1.2 trillion and making the combined firm the 13th largest asset manager by AUM globally and the 6th largest by retail AUM in the U.S. The deal marks a major bet on active management for IVZ, as OppenheimerFunds' products are concentrated in actively-managed, specialized asset classes, including international equity, emerging market equities, and alternative income.

RIA aggregators continued to be active acquirers in the space, with Mercer Advisors (no relation), and United Capital Advisors each acquiring multiple RIAs over the last year. The wealth management consolidator Focus Financial Partners (FOCS) has been active since its July IPO as well. In August, FOCS announced the acquisition of Atlanta-based Edge Capital Group, which manages $3.5 billion in client assets. FOCS also announced several sub-acquisitions by its affiliates during the third quarter.

With over 11,000 RIAs currently operating in the U.S., the industry is still very fragmented and ripe for consolidation. 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. An aging ownership base is another impetus, and recent market gains might induce prospective sellers to finally pull the trigger, which could further facilitate M&A's upward trend during the rest of 2018.

Asset Manager M&A Trends

2008 – Q3 2018



Source: Bloomberg
Transactions involving US-based targets and buyers

Asset Manager Multiples by Sector

	Ticker	9/30/2018 Stock Price	% of 52 Week High	Pricing as of September 30, 2018 Price / Trailing EPS	Price / Forward EPS	Enterprise Value / AUM (%)	Enterprise Value / EBITDA
TRADITIONAL ASSET MANAGERS							
Affiliated Managers Group, Inc.	AMG	$136.72	63.3%	11.0x	11.6x	1.28	11.0x
BlackRock, Inc.	BLK	471.33	80.7%	18.7x	17.0x	1.21	12.3x
Legg Mason, Inc.	LM	31.23	67.3%	10.6x	9.3x	0.59	10.7x
Pzena Investment Management, Inc.	PZN	9.54	76.0%	-9.1x	12.1x	1.69	7.5x
Westwood Holdings Group, Inc.	WHG	51.74	75.8%	15.4x	nm	1.86	10.6x
Group Median			**75.8%**	**11.0x**	**11.8x**	**1.28**	**10.7x**
MUTUAL FUNDS							
AllianceBerstein Investments, Inc.	AB	$30.45	97.5%	11.0x	11.6x	0.56	nm
Cohen & Steers, Inc.	CNS	40.61	87.0%	16.2x	16.5x	2.80	10.2x
INVESCO Ltd.	IVZ	22.88	61.5%	9.2x	8.5x	1.69	10.0x
Franklin Resources, Inc.	BEN	30.41	73.4%	9.3x	10.6x	1.38	4.3x
Diamond Hill Investment Group, Inc.	DHIL	165.39	76.2%	12.6x	nm	2.34	6.3x
Eaton Vance Corp.	EV	52.56	87.7%	16.7x	16.4x	nm	10.6x
Hennessy Advisors, Inc,	HNNA	13.85	70.1%	6.6x	nm	1.69	4.5x
Manning & Napier, Inc.	MN	2.95	71.1%	2.4x	13.7x	nm	nm
T. Rowe Price Group, Inc.	TROW	109.18	86.7%	15.9x	14.9x	2.52	10.4x
U.S. Global Investors, Inc.	GROW	1.52	20.5%	nm	nm	2.43	nm
Waddell & Reed Financial, Inc.	WDR	21.18	91.3%	10.6x	9.7x	1.95	6.1x
Federated Investors, Inc.	FII	24.12	67.6%	11.4x	10.9x	0.60	6.3x
Virtus Investment Partners, Inc.	VRTS	113.75	82.7%	13.2x	9.3x	1.75	8.3x
Group Median			**76.2%**	**11.2x**	**11.2x**	**1.75**	**7.3x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, LLC	APO	$34.55	94.7%	161.8x	22.9x	3.37	8.8x
Blackstone Group L.P.	BX	38.08	93.8%	227.3x	12.3x	8.34	7.3x
Carlyle Group, L.P,	CG	22.55	90.1%	10.2x	9.1x	4.29	6.7x
Kohlberg Kravis Roberts & Co.	KKR	27.27	94.9%	26.7x	16.2x	14.63	nm
Oaktree Capital Group, LLC	OAK	41.40	92.2%	15.7x	15.2x	10.64	15.5x
Och-Ziff Capital Mgmt Group LLC	OZM	1.48	39.6%	1.4x	4.4x	2.61	4.1x
Group Median			**93.0%**	**21.2x**	**13.7x**	**6.31**	**7.3x**
TRUST BANKS							
Northern Trust Corporation	NTRS	$102.13	88.8%	17.3x	15.4x	nm	nm
Bank of New York Mellon Corporation	BK	50.99	87.6%	13.3x	12.2x	nm	nm
State Street Corporation	STT	83.78	74.4%	11.8x	11.1x	nm	nm
Group Median			**87.6%**	**13.3x**	**12.2x**	**nm**	**nm**
OVERALL MEDIAN			**80.7%**	**12.2x**	**12.1x**	**1.90**	**8.6x**

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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, 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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