VALUE FOCUS

Investment Management

Fourth Quarter 2019 | Segment Focus: Wealth Managers

In This Issue

In this issue, we review public market performance across the investment management industry. Publicly traded traditional asset and wealth managers and alternative asset management stocks have increased with the broader market over the last year, while RIA/asset manager aggregator stocks have struggled, ending the year virtually flat. EBITDA multiples for small (<$100B AUM) asset and wealth managers have rebounded from December 2018 lows, but remain below long-term historical averages.

In our segment focus for this quarter, we track the evolution of the wealth management industry over the last decade and look ahead to the next. Aided by a ten-year bull market, the average advisor is managing more assets today than ever before. But it's not all been smooth sailing. The investment management industry has changed radically over the last ten years, and successful wealth management firms have adapted to maintain and grow their client base and remain profitable.

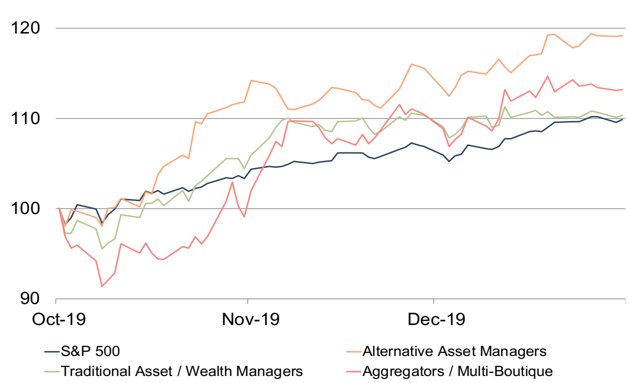
Also in this issue, we address industry M&A trends and factors driving deal activity. Asset and wealth manager M&A continued at a rapid pace during the fourth quarter of 2019, rounding out a record year by many metrics. Acquisitions by RIA aggregators and sub-acquisitions by firms owned by RIA consolidators are growing components of total deal activity in the sector.

Market Overview

All Classes of Investment Management Firms Outperformed the Market Last Quarter

As good as the fourth quarter was for the S&P, it was even better for the RIA industry. All classes of investment management firms bested the market, which was up 10% for the quarter. Continued gains in the equity markets have allowed these firms to more than recover from last year's correction, and many of these businesses are now trading at or near all-time highs.

Investment Management Performance by Sector: Q4 2019

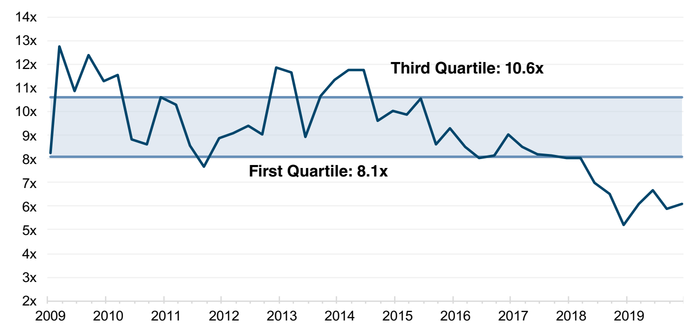


Source: S&P Global Market Intelligence

Despite these gains, the asset management industry is facing numerous headwinds, chief among them being the ongoing pressure for lower fees. Alt managers, on the other hand, are perhaps more insulated from fee pressure due to the lack of passive alternatives to drive fees down.

These headwinds have contributed to a decline in EBITDA multiples for traditional asset managers over the last few years despite the recent uptick in stock price performance. As shown in the next chart, EBITDA multiples for these businesses remain well below historical norms, although they have recovered from their low point in December of 2018.

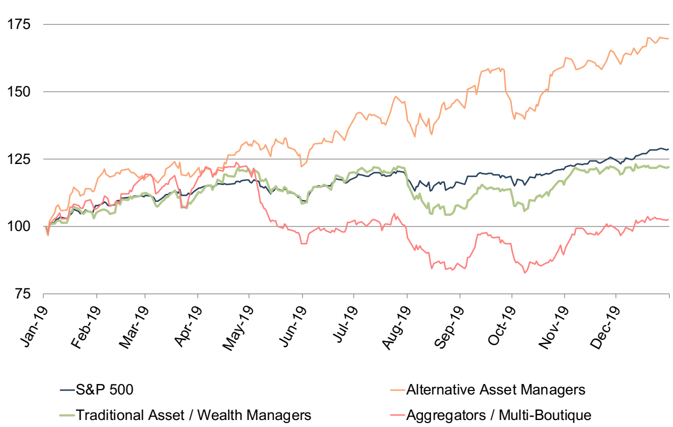
EV / EBITDA Multiples for Public RIAs under $100B AUM (2009 through 12/31/2019)



Source: Bloomberg

Expanding the performance chart over the last year reveals an upward trend in pricing for most classes of RIAs. Over this longer timeframe, alt managers are still the strongest category, although performance has been volatile. Other pure play managers have generally moved in lockstep with the broader market while the aggregators lagged with AMG and FOCS's performance.

Investment Management Performance by Sector: Twelve Months Ended December 31, 2019



Source: S&P Global Market Intelligence

The relative underperformance of the aggregator and multi-boutique index may come as a surprise, given all the press about consolidation in the industry and headline deals for privately held aggregators. Over the last year, there have been two significant deals for privately held wealth management aggregators: **United Capital was bought** by Goldman Sachs for $750 million, and Mercer Advisors' PE backers sold a significant interest to a new PE firm, Oak Hill Capital Management. Both the United Capital and Mercer Advisors deals reportedly occurred at high-teens multiples of adjusted EBITDA.

Implications for Your RIA

With EBITDA multiples for publicly traded asset managers still well below historical norms, it appears the public markets are pricing in many of the headwinds the industry faces. It is reasonable to assume that the same trend will have some impact on the pricing of privately held asset managers as well.

But the public markets are just one reference point that informs the valuation of privately held RIAs, and developments in the public markets may not directly translate to privately held RIAs. Depending on the growth and risk prospects of a particular closely held RIA relative to publicly traded asset and wealth managers, the privately held RIA can warrant a much higher, or much lower, multiple.

Improving Outlook

The outlook for RIAs depends on a number of factors. Investor demand for a particular manager's asset class, fee pressure, rising costs and regulatory overhang can all impact RIA valuations to varying extents. The one commonality, though, is that RIAs are all impacted by the market. Their product is, after all, the market.

The impact of market movements varies by sector, however. Alternative asset managers tend to be more idiosyncratic but are still influenced by investor sentiment regarding their hard-to-value assets. Wealth manager valuations are tied to the demand from consolidators while traditional asset managers are more vulnerable to trends in asset flows and fee pressure. Aggregators and multi-boutiques are in the business of buying RIAs, and their success depends on their ability to string together deals at attractive valuations with cheap financing.

On balance, the outlook for RIAs appears to have improved since the significant market drop in December 2018. Since then, industry multiples have rebounded somewhat, and the broader market has recovered its losses and then some—which should have a positive impact on future RIA revenues and earnings.

More attractive valuations could entice more M&A, coming off the heels of **a record year in asset manager deal making**.

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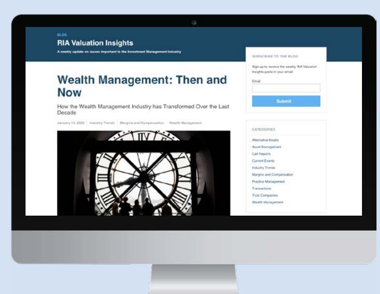

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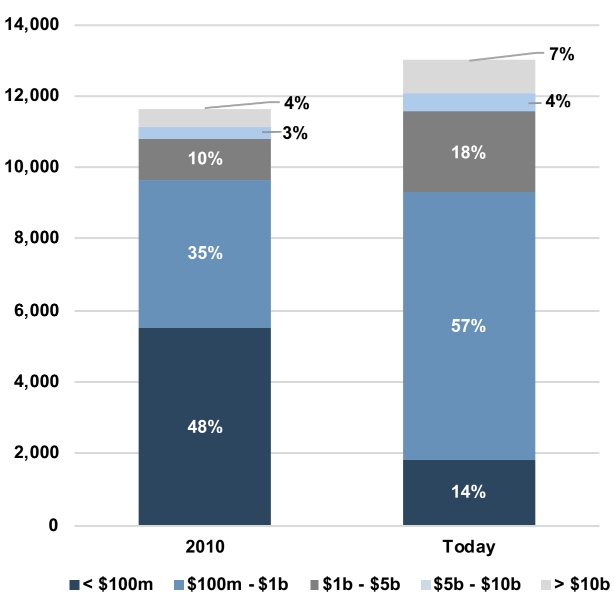
Segment Focus: Wealth Managers

How the Wealth Management Industry Has Transformed Over the Last Decade

According to the **Investment Advisor Association's** 2010 publication, SEC registered Investment Advisors reported $38.6 trillion in assets under management in 2010. Today, that number has more than doubled to $83.7 trillion. The number of SEC registered investment advisors, however, has only increased by 12% (11,643 in 2010 and 12,993 today). This means that the average advisor is managing more money today than they were ten years ago, as shown in the graph below.

In 2010, advisors reportedly served approximately 30 million clients compared to 43 million today, suggesting that the increase in assets managed by each advisor is a result of having both more and larger clients.

Number of SEC-Registered Investment Advisors by AUM Category



Source: Bloomberg

These statistics suggest it's been smooth sailing for wealth managers. However, the investment management industry has changed radically over the last ten years, and wealth managers have been forced to adapt in order to maintain their client base and remain profitable. While these changes have not been easy, they have transformed the industry into one more focused on its clients' needs and better regulated to ensure the safety of its clients' assets.

Backdrop

The popularity of passive funds increased in 2009 when the current bull market began. In 2010, about 30% of US assets were held in passively managed funds; last year, we crossed the 50% mark. While active versus passive may still be an intellectual debate, there's no debate that trillions of dollars are managed passively today at much lower fees than they were a decade ago. The chart on the next page, demonstrates the decline in publicly traded investment managers' effective fees over the last ten years.

Wealth managers, however, have largely side-stepped fee pressure so far, and we don't hear many instances of wealth management firms bending their stated pricing schedules because of client pushback. However, to justify higher fees in a low fee environment, wealth managers have had to differentiate themselves by providing more specialized solutions for their clients. Ten years ago, Westwood Holdings, a publicly traded wealth management firm, described themselves as follows on their website: *Westwood is built upon one investment philosophy of controlling overall portfolio risk while providing superior, risk-adjusted returns for our clients.*

Today Westwood's website touts: *At Westwood, we will champion **your values** and help make **your intentions** a reality.*

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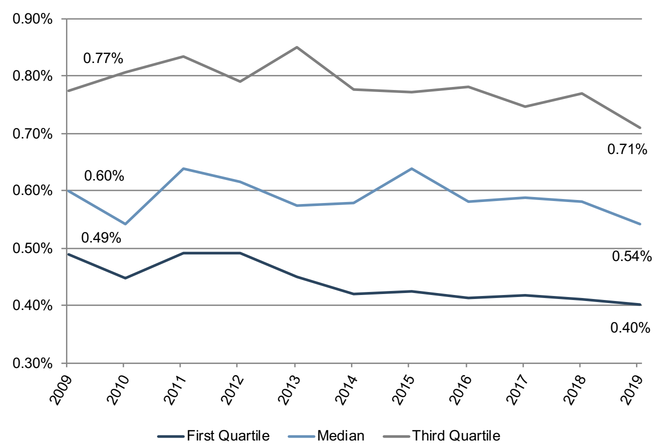
Effective Fees of Publicly Traded Investment Managers



Source: Bloomberg

Wealth mangers have changed their marketing strategy to highlight their more tailored investment solutions (with the underlying message that specialized services are worth the higher fees). But their ability to maintain their fee schedules will likely depend on their capacity to continue servicing clients' evolving needs while connecting with their next generation.

The trade-off with more specialized investment management is the cost. Providing tailored investment solutions, takes more time, i.e. more human capital. One area where the asset management model beats wealth management is scalability. You can build a bigger wealth management firm, but it usually requires a corresponding increase in advisors and planners. Additionally, as compliance and technology costs have increased over the last decade, wealth managers have had to pay closer attention to their expense base then they had to ten years ago.

At the same time, many principals of wealth management firms reached retirement age over the last decade, often with no plan in place to transition their business. Succession planning has been an area of increasing focus in the RIA industry, particularly given what many are calling a looming succession crisis. In **Schwab's 2019 benchmarking study**, which surveyed 1,300 RIAs, a full 92% of respondents indicated that they were considering internal succession, but only 38% of firms have a documented path to partnership. **The options for aging principals have exploded over the last decade.** Debt financing providers have bettered the terms for RIAs, private equity firms are giving more attention to the industry, and M&A opportunities have increased as RIAs try to achieve scale.

Most notably, however, is the increase of consolidators in the space. RIA consolidators have seized the opportunity to address both the needs of retiring shareholders and continuing principals, by offering liquidity for founders as well as back-office infrastructure. Consolidators can provide selling partners with substantial liquidity at close, an ongoing interest in the economics of the firm, and a mechanism to transfer the sellers' continued interest to the next generation of management. Additionally, they can offer back office services such as IT, compliance, and human resources which allows RIAs to preserve their margins despite the cost of hiring more advisors.

2020 Vision

Looking forward, wealth managers will have to continue streamlining back office processes so that they can prioritize spending on compensation. Investments in technology and compliance will continue to require additional resources. Wealth managers must make conscious decisions about where they will find cost saving efficiencies without sacrificing superior service for their clients.

Going forward, more and more RIAs will have to evaluate offers from consolidators and decide whether this kind of partnership is right for them. Planning ahead for the eventual transition of your business will set you up with more options for retirement and a better understanding of where you are willing to make concessions.

RIA Consolidators Drive Record Deal Activity in 2019

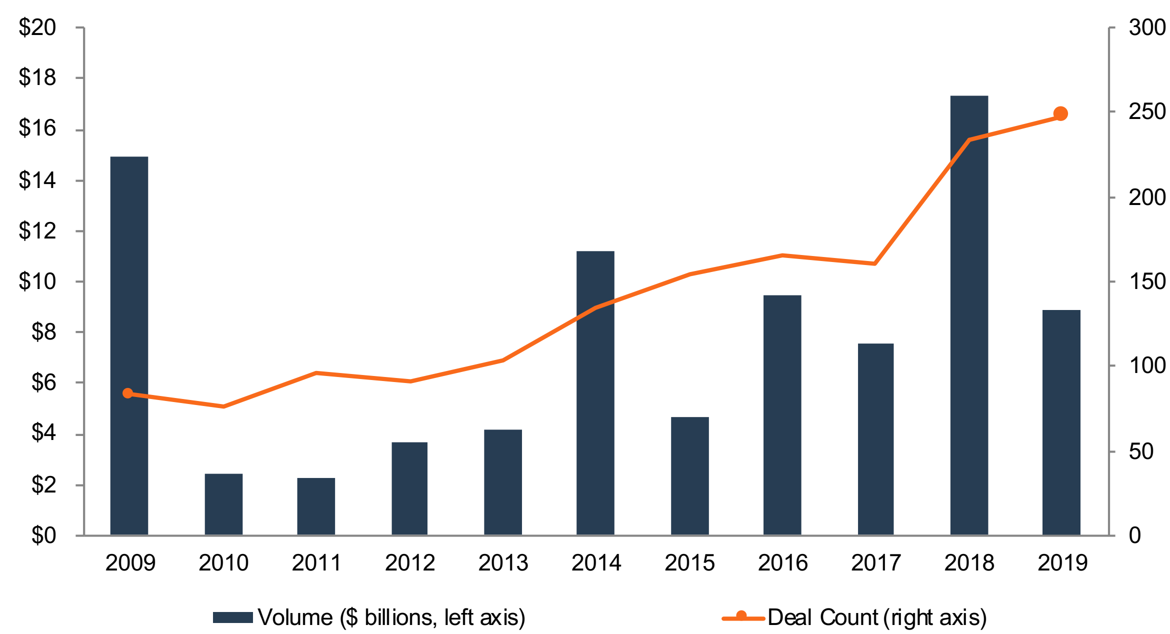
Asset and Wealth Manager M&A Continues Decade-Long Upward Trend

Asset and wealth manager M&A continued at a rapid pace during the fourth quarter of 2019, rounding out a record year by many metrics. Total deal count in 2018 rose 6% over 2018, reaching the highest level seen over the last decade. While reported deal volume declined by 50% in 2019, this metric can be a less reliable indicator of transaction activity given the lack of disclosed deal terms and the influence of large transactions (the Oppenheimer/Invesco deal accounted for about a quarter of 2018 reported deal volume, for example).

The rise of the RIA consolidator model continues to be a theme for the wealth management sector. Wealth management firms saw a significant uptick in consolidation activity during 2019, which was attributable in large part to strategic consolidators. According to **Fidelity's December 2019 Wealth Management M&A Transaction Report**, there were 139 wealth management transactions in 2019 (43% more than 2018) representing $780 billion in assets (38% more than 2018). Some of the more active consolidators included Focus Financial, Mercer Advisors, Wealth Enhancement Group, HighTower Advisors, and Dynasty Financial Partners—each of whom acquired multiple RIAs during 2019.

RIA consolidators now account for about half of wealth management acquisition activity—and that percentage has been increasing. These consolidators are, in general, well-funded (often by PE backers) and have a mandate from their investors to grow rapidly via acquisitions. They're also not shy about knocking on doors to source deals, and given the demographics of the wealth management industry, their pitch for an exit plan often finds a receptive audience.

Asset Manager M&A (2009 – Q4 2019)



Source: Bloomberg
Transactions involving U.S.-based targets and buyers

Sub-acquisitions by consolidator-owned RIAs are a further driver of M&A activity for the sector. These acquisitions are typically much smaller and are facilitated by the balance sheet and M&A experience of the consolidators. For some RIAs acquired by consolidators, the prospect of using buyer resources to facilitate their own M&A may be a key motivation for joining the consolidator in the first place.

There have also been several significant transactions of the consolidators themselves, which illustrates the broad investor interest in the consolidator model. One of the largest deals of 2019 was Goldman Sachs's bid to enter the mass-affluent wealth management market through its $750 million acquisition of RIA consolidator United Capital Partners. Also during 2019, Mercer Advisors' PE backers sold a significant interest to Oak Hill Capital Partners.

Consolidation Rationales

Building scale to enhance margins and improve competitive positioning are typical catalysts for consolidation, especially on the asset management side. One way to stem the tide of fee pressure and asset outflows is to cut costs through synergies to preserve profitability as revenue skids. The lack of internal succession planning is another driver as founding partners look to outside buyers to liquidate their holdings.

Consolidating RIAs, which are typically something close to "owner-operated" businesses, is no easy task. The risks include cultural incompatibility, lack of management incentive, and size-impeding alpha generation. Many RIA consolidators structure deals to mitigate these problems by providing management with a continued interest in the economics of the acquired firm while allowing it to retain its own branding and culture. Other acquirers take a more involved approach, unifying branding and presenting a homogeneous front to clients in an approach that may offer more synergies, but may carry more risks as well.

M&A Outlook

The record transaction activity in 2019 marks a decade-long run of steadily increasing consolidation activity in the sector. In 2020, we expect the trend to continue as many of the forces that shaped the industry over the last decade remain in place. Consolidation pressures in the industry are largely the result of secular trends. On the revenue side, realized fees continue to face pressure as funds flow from active to passive and clients become increasingly fee conscious. On the cost side, an evolving regulatory environment threatens increasing technology and compliance costs. The continuation of these trends will pressure RIAs to seek scale, which will in turn will drive further M&A activity.

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 struggle with organic growth and margin compression. An aging ownership base is another impetus. The performance of the broader market will also be a key consideration for both buyers and sellers in 2020.

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Investment Manager Multiples by Sector

				Pricing as of Dec. 31, 2019			
	Ticker	12/31/2019 Stock Price	% of 52 Week High	Price / Trailing EPS	Price / Forward EPS	Enterprise Value / AUM (%)	Enterprise Value / EBITDA
TRADITIONAL ASSET / WEALTH MANAGERS (AUM UNDER $100B)							
Diamond Hill Investment Group, Inc.	DHIL	140.46	83.7%	12.8x	nm	1.68	5.5x
GAMCO Investors, Inc.	GBL	19.49	85.4%	5.7x	nm	1.35	4.0x
Hennessy Advisors, Inc,	HNNA	10.08	78.9%	7.1x	nm	1.41	4.2x
Pzena Investment Management, Inc.	PZN	8.62	82.7%	11.9x	nm	1.81	8.7x
Silvercrest Asset Management Group	SAMG	12.58	78.4%	10.0x	7.7x	0.98	8.4x
Westwood Holdings Group, Inc.	WHG	29.62	74.4%	26.6x	nm	1.44	12.4x
Waddell & Reed Financial, Inc.	WDR	16.72	87.2%	8.7x	11.1x	1.80	6.1x
Group Median			**82.7%**	**10.0x**	**9.4x**	**1.44**	**6.1x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $100B)							
AllianceBerstein Investments, Inc.	AB	30.26	96.3%	13.3x	10.6x	1.86	nm
BlackRock, Inc.	BLK	502.70	99.2%	19.7x	16.5x	1.17	14.1x
Eaton Vance Corp.	EV	46.69	95.3%	14.3x	13.2x	1.45	12.7x
Federated Investors, Inc.	FII	32.59	90.6%	13.0x	11.5x	0.67	9.5x
Franklin Resources, Inc.	BEN	25.98	72.5%	10.3x	10.2x	1.33	5.3x
Invesco Ltd.	IVZ	17.98	81.1%	8.1x	6.8x	1.36	15.5x
Legg Mason, Inc.	LM	35.91	89.2%	10.4x	9.7x	0.72	37.5x
T. Rowe Price Group, Inc.	TROW	121.84	96.6%	15.5x	14.7x	2.45	10.9x
Virtus Investment Partners, Inc.	VRTS	121.72	96.2%	11.8x	7.8x	1.06	6.3x
Group Median			**95.3%**	**13.0x**	**10.6x**	**1.33**	**11.8x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	APO	47.71	97.8%	22.3x	16.5x	4.14	17.0x
Ares Management Corp	ARES	35.69	99.0%	28.2x	18.7x	9.29	19.1x
Associated Capital Group Inc	AC	39.20	86.0%	nm	nm	37.76	nm
Blackstone Group Inc/The	BX	55.94	98.7%	24.8x	18.3x	9.89	19.3x
Carlyle Group LP/The	CG	32.08	98.7%	9.7x	13.8x	3.13	4.6x
Cohen & Steers Inc	CNS	62.76	92.0%	24.9x	21.6x	4.15	15.6x
Hamilton Lane Inc	HLNE	59.60	92.2%	36.6x	30.4x	8.80	27.0x
KKR & Co Inc	KKR	29.17	96.7%	15.2x	14.3x	27.65	nm
Sculptor Capital Management Inc	SCU	22.10	86.7%	nm	5.8x	6.19	165.8x
Group Median			**96.7%**	**24.8x**	**17.4x**	**8.80**	**19.1x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	84.74	73.2%	13.3x	10.6x	0.94	8.3x
Artisan Partners Asset Management Inc.	APAM	32.32	99.2%	13.1x	11.5x	2.35	9.7x
Focus Financial Partners Inc	FOCS	29.47	73.0%	14.3x	13.2x	na	15.9x
Victory Capital Holdings Inc	VCTR	20.97	94.2%	13.0x	11.5x	4.45	16.1x
Group Median			**83.7%**	**13.2x**	**11.5x**	**2.35**	**12.76**
OVERALL MEDIAN			**90.6%**	**13.1x**	**11.5x**	**1.81**	**11.7x**

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Source: Bloomberg

Mercer Capital's Investment Management Industry Expertise

Mercer Capital provides RIAs, independent trust companies, and alternative asset managers with business valuation and financial advisory services related to corporate disputes, litigated matters, tax compliance, and financial reporting requirements. Mercer Capital also provides transaction advisory and consulting-related services.

Mercer Capital provides a comprehensive suite of valuation and financial advisory services to meet your needs. Experience includes:

- Corporate valuation services for clients ranging from start up managers with as little as $50 million in assets under management to established industry leaders managing over $400 billion
- Litigation support services and expert witness testimony in matters involving economic damages, shareholder disputes, and marital dissolution
- Transaction advisory services involving investment managers from sell-side, buy-side, and mutually retained perspectives
- Providing financial statement reporting services related to purchase price allocation and goodwill impairment testing
- Assisting RIAs and other investment managers with annual ESOP valuations, fairness opinions, and appraisals for gift and estate tax compliance

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- Financial Reporting Valuation
- Tax Compliance Valuation
- Litigation & Dispute Resolution Consulting/ Testimony
- ERISA Valuation

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