VALUE FOCUS

Asset Management Industry

SEGMENT FOCUS

Traditional Asset Managers

2016

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Segment Focus

Traditional Asset Managers

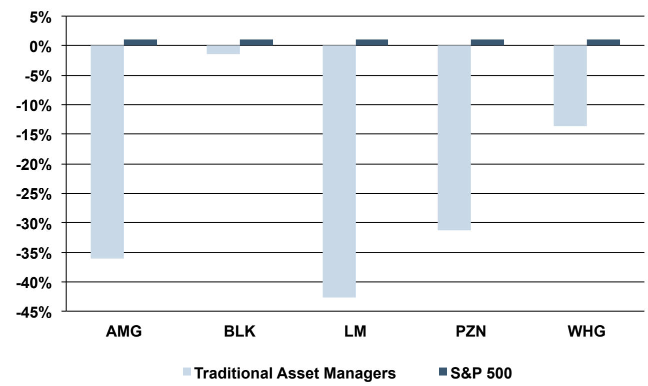
Often branded as an industry bellwether for its size and breadth of services, **BlackRock** (ticker: **BLK**) has been as solid as the name would imply **given the recent fallout in asset manager valuations**. In the most recent earnings call, CEO Larry Fink attributes the company's recent success to "the differentiating platform we have built at BlackRock over the past 28 years…, the diversity of our product offerings, the risk capabilities of Aladdin, [and] the market insights offered by the BlackRock Investment Institute."

Specifically, BLK benefited from $126 billion in net inflows over the last year as many RIAs have leaked client assets to passive funds and robo-advisors. BlackRock is clearly gaining market share within the industry and currently manages $4.9 trillion in client assets. This scale has allowed it to make the necessary investments in technology and talent to continue the upward growth trajectory in a sideways market. In addition, BlackRock has also recently invested in ETF businesses to take advantage of the rising popularity of indexing strategies. In essence, BlackRock has used its size (and balance sheet) to evolve with the industry and gain market share in the process.

Still, the last twelve months have been challenging for most other components of our traditional asset manager index. A low yield environment dominated by ETFs and passive products has not been conducive to many RIAs, especially active managers like Pzena and Legg Mason, which are down 31% and 43%, respectively, over the six months ended June 30, 2016.

Share Price Performance

Twelve Months Ended June 30, 2016



Source: S&P Global Market Intelligence

As discussed in the **Market Overview on page 2**, investors are growing increasingly intolerant of the high fee/low performance combination, so both traditional and alternative asset managers are feeling the heat. Mounting regulatory pressures are additional headwinds as the Financial Stability Oversight Council is currently reviewing six areas of the asset management business for potential enhancements to regulatory oversight – liquidity and redemption, leverage, securities lending, data and disclosure, operational risk of service provider concentrations, and resolvability and transition planning. The SEC is also assessing the sector's systemic risk exposure and should finalize three proposals on mutual fund and ETF regulation in the back half of the year.

What We're Reading

SEC proposes rule 206(4)-4: Adviser Business Continuity and Transition Plans
Deloitte: Damian Walch
http://mer.cr/2aTGSm4

Where Do You Find Financial Advisory Firms For Sale?
Michael Kitches
http://mer.cr/2ax9YIU

Trouble Looms for Small RIAs in Next Bear Market
Investment News: Christine Idzelis
http://mer.cr/2aQBrTT

Market Overview
Second Quarter 2016

Piggybacking off our ***RIA Valuation Insights*** post "**Gimme Shelter**" from the beginning of July, the downward trend in asset manager pricing has persisted for another quarter, no matter how you slice it. Publicly traded trust banks, alt managers, mutual funds, and traditional RIAs are all down over the last year, with hedge funds and PE firms leading the plunge. Rising compliance costs, fee and margin compression, asset outflows on active strategies, and stalling growth prospects are all culprits for the overall decline, but alternative asset managers have definitely been hit the hardest over the last year.

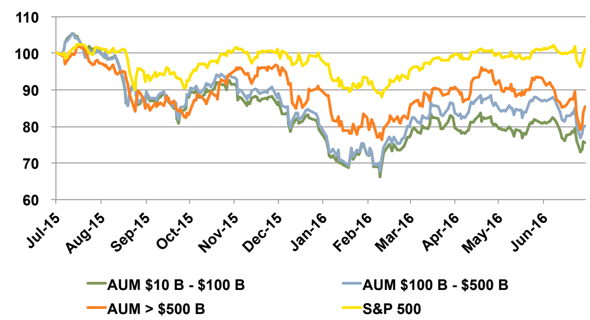
As a matter of practicality, it shouldn't be surprising that the most expensive asset class with the worst overall performance would eventually be shunned by investors. This trend is really just a microcosm or more exaggerated example of what's going on across the entire asset manager landscape – individual and institutional investors no longer have to accept high fees and chronic underperformance, so they're turning their attention to passively managed products or indexing strategies to boost their effective return.

There was also virtually no size effect. Most every asset manager from **GROW** (**U.S. Global**) to **TROW** (**T. Rowe Price**) has struggled to keep pace with the broader indices. No matter the asset base, a low-fee, passively biased environment is not conducive to most asset managers of any size, shape, or form. Add rising regulatory costs and a market that's not exactly undervalued, and you get multiple contraction and a bear market for RIAs.

So what's the market trying to tell us about the future of this business? Probably that fee compression, asset outflows, rising compliance costs, and heightened market volatility will likely have an adverse effect on future earnings for some time to come. For alternative asset managers, the market seems to be pricing in more pronounced cuts to their fee structure and/or continued outflows.

Asset Managers Index

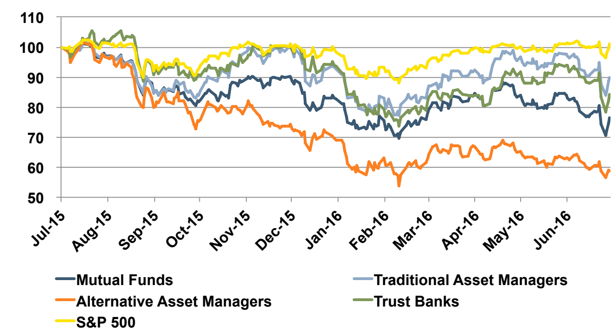
Breakdown by Size



Source: S&P Global Market Intelligence

Asset Managers Index

Breakdown by Type



Source: S&P Global Market Intelligence

M&A Review

On July 5, **Affiliated Managers Group** (ticker: **AMG**) announced the completion of its investment in three alternative asset managers – Capula Investment Management LLP, Mount Lucas Management LP, and Capeview Capital LLP. These transactions are the cornerstone of AMG's 6/6/16 definitive agreement with Petershill Fund I, a group of investment vehicles managed by Goldman Sachs Asset Management, LP, to acquire all of Petershill's minority interests in the aforementioned firms as well as two other alternative investment managers, Partner Fund Management and Winton Capital Group, which haven't yet closed.

Under the terms of the agreement, AMG will acquire these interests for approximately $800 million to be paid in cash at closing (roughly half of which was just paid for Capula, Mount Lucas, and Capeview with the balance expected to close by year-end). Given that RIA disclosures only present ownership percentages in range form and three of the entities are headquartered in London, the ADV is of little use to us in ascertaining the exact interest acquired in these businesses (though it's probably safe to assume something close to 50% given their typical investment structure as discussed in "**Brexit and Killen Underscore the Need for Buyer Protection in Asset Manager Transactions**" on our blog, ***RIA Valuation Insights***).

Perhaps more instructive is AMG's admission that management expects the transaction to increase economic earnings per share by $0.50 to $0.80 in 2017, availing some insight on deal pricing (though much of this accretion is likely due to synergies).

At first glance an effective multiple of 18-29x next year's earnings seems a bit rich, even in this market, but closer inspection reveals pricing more in line with industry peer measures. The high level of variance in the metrics is largely attributable to the uncertain and variable nature of performance fees and carried interest income as well as relatively depressed earnings for many alternative asset managers.

AMG apparently sees this decline as a buying opportunity, since these businesses might be the cheapest they've been in quite some time. And although trying to catch a falling knife is typically ill-advised, AMG has partially hedged this risk by investing in established hedge fund managers with over $1 billion in client assets. At any rate, the market doesn't seem convinced as AMG shares were off 23% in the month of June.

Recent AMG Acquisitions

	Pricing Metrics	
Expected EPS Accretion	$0.50	$0.80
Shares Outstanding	55,800,000	55,800,000
Total Earnings Accretion	$27,900,000	$44,640,000
Total Consideration Paid	$800,000,000	$800,000,000
Implied Forward P/E Multiple	***28.7x***	***17.9x***

Source: S&P Global Market Intelligence

Asset Manager Multiples by Sector

	Ticker	6/30/2016 Stock Price	% of 52 Week High	Pricing as of June 30, 2016 Price / Trailing EPS	Price / Forward EPS	Total Capital / AUM	Total Capital / EBITDA
TRADITIONAL ASSET MANAGERS							
Affiliated Managers Group, Inc.	AMG	140.77	63.47%	11.65	12.72	1.64	11.48
BlackRock, Inc.	BLK	342.53	93.33%	18.06	17.60	1.19	11.72
Legg Mason, Inc.	LM	29.49	57.31%	10.90	8.79	0.53	32.46
Pzena Investment Management, Inc.	PZN	7.61	65.86%	15.29	19.03	1.83	9.88
Westwood Holdings Group, Inc.	WHG	51.80	85.29%	16.16	nm	1.93	10.03
Group Median			**65.86%**	**15.29**	**15.16**	**1.64**	**11.48**
MUTUAL FUNDS							
AllianceBerstein Investments, Inc.	AB	23.30	83.71%	11.65	12.72	0.48	nm
Calamos Asset Management, Inc.	CLMS	7.31	61.66%	193.90	54.96	0.40	2.18
Cohen & Steers, Inc.	CNS	40.44	96.09%	25.98	21.17	3.29	15.06
GAMCO Investors, Inc.	GBL	32.77	78.69%	10.28	8.88	2.97	8.36
INVESCO Ltd.	IVZ	25.54	67.01%	11.23	11.23	1.82	10.83
Franklin Resources, Inc.	BEN	33.37	68.10%	12.19	12.35	1.70	4.78
Diamond Hill Investment Group, Inc.	DHIL	188.42	81.27%	16.92	nm	3.50	10.20
Eaton Vance Corp.	EV	35.34	90.86%	17.31	16.82	nm	10.05
Hennessy Advisors, Inc,	HNNA	33.47	84.73%	13.50	nm	3.12	8.24
Manning & Napier, Inc.	MN	9.50	88.53%	12.03	12.82	0.13	0.45
T. Rowe Price Group, Inc.	TROW	72.97	93.06%	16.59	16.22	2.21	8.64
U.S. Global Investors, Inc.	GROW	1.70	59.47%	(4.61)	nm	3.15	nm
Waddell & Reed Financial, Inc.	WDR	17.22	38.03%	6.65	8.81	1.07	2.63
Federated Investors, Inc.	FII	28.78	85.62%	16.57	14.94	0.85	9.73
Virtus Investment Partners, Inc.	VRTS	71.18	50.70%	13.32	13.71	1.08	8.37
Janus Capital Group Inc.	JNS	13.92	81.90%	14.98	15.52	1.41	7.61
Group Median			**81.58%**	**13.41**	**13.71**	**1.70**	**8.36**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, LLC	APO	15.15	72.35%	37.42	15.57	2.43	15.41
Brookfield Asset Management, Inc.	BAM.A	33.07	93.05%	18.68	25.05	nm	17.99
Blackstone Group L.P.	BX	24.54	62.71%	208.67	10.44	10.07	40.82
Carlye Group, L.P,	CG	16.23	62.16%	nm	11.26	2.27	3.90
Fortress Investment Group LLC	FIG	4.42	63.60%	11.63	4.94	2.44	6.49
Kohlberg Kravis Roberts & Co.	KKR	12.34	52.84%	nm	19.78	18.74	nm
Oaktree Capital Group, LLC	OAK	44.76	82.32%	39.44	20.01	9.95	nm
Och-Ziff Capital Mgmt Group LLC	OZM	3.80	30.59%	4.61	105.56	4.46	366.15
Group Median			**63.16%**	**28.05**	**17.67**	**4.46**	**16.70**
TRUST BANKS							
Northern Trust Corporation	NTRS	66.26	85.36%	16.42	15.68	nm	nm
Bank of New York Mellon Corporation	BK	38.85	86.59%	13.26	12.63	nm	nm
State Street Corporation	STT	53.92	67.88%	10.89	11.33	nm	nm
Group Median			**85.36%**	**13.26**	**12.63**	**nm**	**nm**
OVERALL MEDIAN			**75.52%**	**14.24**	**14.33**	**1.93**	**9.88**

Data Source: S&P Global Market Intelligence

Fairness Considerations for Mergers of Equals

When asked about his view of a tie years before the NCAA instituted the playoff format in the 1990s, Coach Bear Bryant famously described the outcome as "kissing your sister." If he were a portfolio manager holding a position in a company that entered into a merger of equals (MOE), his response might be the same. Wall Street generally does not like MOEs unless the benefits are utterly obvious and/or one or both parties had no other path to create shareholder value. In some instances, MOEs may be an intermediate step to a larger transaction that unlocks value. National Commerce Financial Corporation CEO Tom Garrott once told me that part of his rationale for entering into a $1.6 billion MOE with CCB Financial Corp. in 2000 that resulted in CCB owning 47% of the company was because bankers told him he needed a bigger retail footprint to elicit top dollar in a sale. It worked. National Commerce agreed to be acquired by SunTrust Banks, Inc. in 2004 in a deal that was valued at $7 billion.

Kissing Your Sister?

MOEs, like acquisitions, typically look good in a PowerPoint presentation, but can be tough to execute. Busts from the past include Daimler-Benz/Chrysler Corporation and AOL/Time Warner. Among banks the 1994 combination of Cleveland-based Society Corporation and Albany-based KeyCorp was considered to be a struggle for several years, while the 1995 combination of North Carolina-based Southern National Corp. and BB&T Financial Corporation was deemed a success.

The arbiter between success and failure for MOEs typically is culture, unless the combination was just a triumph of investment banking and hubris, as was the case with AOL/Time Warner. The post-merger KeyCorp struggled because Society was a centralized, commercial-lending powerhouse compared to the decentralized, retail-focused KeyCorp. Elements of both executive management teams stuck around. Southern National, which took the BB&T name, paid the then legacy BB&T management to go away. At the time there was outrage expressed among investors at the amount, but CEO John Allison noted it was necessary to ensure success with one management team in charge. Likewise, National Commerce's Garrott as Executive Chairman retained the exclusive option to oust CCB's Ernie Roessler, who became CEO of the combined company, at the cost of $10 million if he chose to do so. Garrett exercised the option and cut the check in mid-2003 three years after the MOE was consummated.

Fairness Opinions for MOEs

MOEs represent a different proposition for the financial advisor in terms of rendering advice to the Board. An MOE is not the same transaction as advising a would-be seller about how a take-out price will compare to other transactions or the company's potential value based upon management's projections. The same applies to advising a buyer regarding the pricing of a target. In an MOE (or quasi-MOE) both parties give up 40-50% ownership for future benefits with typically little premium if one or both are publicly traded. Plus there are the social issues to navigate.

While much of an advisor's role will be focused on providing analysis and advice to the Board leading up to a meaningful corporate decision, the fairness opinion issued by the advisor (and/or second advisor) has a narrow scope. Among other things a fairness opinion does not opine:

- The course of action the Board should take;
- The contemplated transaction represents the highest obtainable value;
- Where a security will trade in the future; and
- How shareholders should vote.

What is opined is the fairness of the transaction from a financial point of view of the company's shareholders as of a specific date and subject to certain assumptions. If the opinion is a sell-side opinion, the advisor will opine as to the fairness of the consideration received. The buy-side opinion will opine as to the fairness of the consideration paid. A fairness opinion for each respective party to an MOE will opine as to the fairness of the exchange ratio because MOEs largely entail stock-for-stock structures.

Explaining the benefits of an MOE and why ultimately the transaction is deemed to be fair in the absence of a market premium can be challenging. The pending MOE among Talmer Bancorp Inc. (45%) and Chemical Financial Corp. (55%) is an example. When the merger was announced on January 26, the implied value for Talmer was $15.64 per share based upon the exchange ratio for Chemical shares (plus a small amount of cash). Talmer's shares closed on January 25, 2016 at $16.00 per share. During the call to discuss the transaction, one analyst described the deal as a "take under" while a large institutional investor said he was "incredibly disappointed" and accused the Board of not upholding its fiduciary duty. The shares dropped 5% on the day of the announcement to close at $15.19 per share.

Was the transaction unfair and did the Board breach its fiduciary duties (care, loyalty and good faith) as the institutional shareholder claimed? It appears not. The S-4 notes Talmer had exploratory discussions with other institutions, including one that was "substantially larger"; yet none were willing to move forward. As a result an MOE with Chemical was crafted, which includes projected EPS accretion of 19% for Talmer, 8% for Chemical, and a 100%+ increase in the cash dividend to Talmer shareholders. Although the fairness opinions did not opine where Chemical's shares will trade in the future, the bankers' analyses noted sizable upside if the company achieves various peer-level P/Es. (As of mid-July 2016, Talmer's shares were trading around $20 per share.)

Fairness is not defined legally. The Merriam-Webster dictionary defines "fair" as "just, equitable and agreeing with what is thought to be right or acceptable." Fairness when judging a corporate transaction is a range concept. Some transactions are not fair, some are in the range—reasonable, and others are very fair.

The concept of "fairness" is especially well-suited for MOEs. MOEs represent a combination of two companies in which both shareholders will benefit from expense savings, revenue synergies and sometimes qualitative attributes. Value is an element of the fairness analysis, but the relative analysis takes on more importance based upon a comparison of contributions of revenues, earnings, capital and the like compared to pro forma ownership.

Investment Merits to Consider

A key question to ask as part of the fairness analysis: are shareholders better off or at least no worse for exchanging their shares for shares in the new company and accepting the execution risks? In order to answer the question, the investment merits of the pro forma company have to be weighed relative to each partner's attributes.

» **Profitability and Revenue Trends.** The analysis should consider each party's historical and projected revenues, margins, operating earnings, dividends and other financial metrics. Issues to be vetted include customer concentrations, the source of growth, the source of any margin pressure and the like. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated.

» **Expense Savings.** How much and when are the savings expected to be realized. Do the savings come disproportionately from one party? Are the execution risks high? How does the present value of the after-tax expense savings compare to the pre-merger value of the two companies on a combined basis?

» **Pro Forma Projected Performance.** How do the pro forma projections compare with each party's stand-alone projections? Does one party sacrifice growth or margins by partnering with a slower growing and/or lower margin company?

- **Per Share Accretion.** Both parties of an MOE face ownership dilution. What is obtained in return in terms of accretion (or dilution) in EBITDA per share, (for non-banks) tangible BVPS, EPS, dividends and the like?

- **Distribution Capacity.** One of the benefits of a more profitable company should be (all else equal) the capacity to return a greater percentage of earnings (or cash flow) to shareholders in the form of dividends and buybacks.

- **Capital Structure.** Does the pro forma company operate with an appropriate capital structure given industry norms, cyclicality of the business and investment needs to sustain operations? Is there an issue if one party to an MOE is less levered and the other is highly levered?

- **Balance Sheet Flexibility.** Related to the capital structure should be a detailed review of the pro forma company's balance sheet that examines such areas as liquidity, funding sources, and the carrying value of assets such as deferred tax assets.

- **Consensus Analyst Estimates.** This can be a big consideration in terms of Street reaction to an MOE for public companies. If pro forma EPS estimates for both parties comfortably exceed Street estimates, then the chances for a favorable reaction to an MOE announcement improve. If accretion is deemed to be marginal for the risk assumed or the projections are not viewed as credible, then reaction may be negative.

- **Valuation.** The valuation of the combined company based upon pro forma per share metrics should be compared with each company's current and historical valuations and a relevant peer group. Also, while no opinion is expressed about where the pro forma company's shares will trade in the future, the historical valuation metrics provide a context to analyze a range of shareholder returns if earning targets are met under various valuation scenarios. This is particularly useful when comparing the analysis with each company on a stand-alone basis.

- **Share Performance.** Both parties should understand the source of their shares and the other party's share performance over multi-year holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or, is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.

- **Liquidity of the Shares.** How much is liquidity expected to improve because of the MOE? What is the capacity to sell shares issued in the merger? SEC registration and even NASADQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently.

- **Strategic Position.** Does the pro forma company have greater strategic value as an acquisition candidate (or an acquirer) than the merger partners individually?

Conclusion

The list does not encompass every question that should be asked as part of the fairness analysis for an MOE, but it points to the importance of vetting the combined company's investment attributes as part of addressing what shareholders stand to gain relative to what is relinquished. We at Mercer Capital have over 30 years of experience helping companies and financial institutions assess significant transactions, including MOEs. Do not hesitate to contact us to discuss a transaction or valuation issue in confidence.

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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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