VALUE FOCUS

Asset Management Industry

SEGMENT FOCUS

Alternative Asset Managers

2017

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Q1: Mutual Funds

Q2: Traditional Asset Managers

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Q4: Trust Banks

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Segment Focus
Alternative Asset Managers

The recent woes surrounding the alt asset space are **well documented**. Fee pressure, expanding index opportunities, and relative underperformance have plagued the industry in recent years despite favorable market returns. These headwinds led to significant declines in share prices for publicly traded hedge funds and private equity firms when we wrote about this topic last year (as shown in Chart 1).

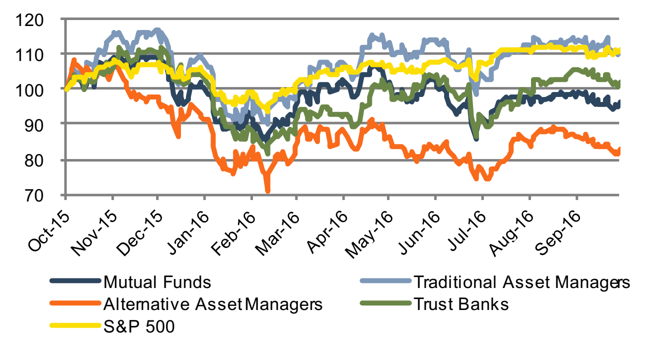
But one year later, things seem to be looking up for the industry. Improving performance, favorable capital markets, the potential for enduring low tax rates on carried interest, and generally robust economic conditions have precipitated a nice turnaround for these businesses that have generally lagged other classes of asset managers in prior years (Chart 2).

Despite the recent uptick, we don't think these businesses are quite out of the woods just yet. Performance fees are likely to continue their decline to keep pace with the rising popularity of passive investing. **Recent scandals** have adversely affected their reputation within the investing community. Relative underperformance over the long-run has also diminished the value-added proposition of active management and hedge fund investing (see Chart 3 on the next page).

And yet the industry has endured and performed reasonably well over the last year, at least in the eyes of market participants. Most investors value the diversification offered by alternative investors, especially when other asset classes appear relatively rich. Active management may not be as lucrative as it once was, but is still sought by many institutional investors to complement their passive holdings. Though the market seemed to be questioning the long-term viability of these businesses last year, it appears to have

Chart 1: Asset Management Performance

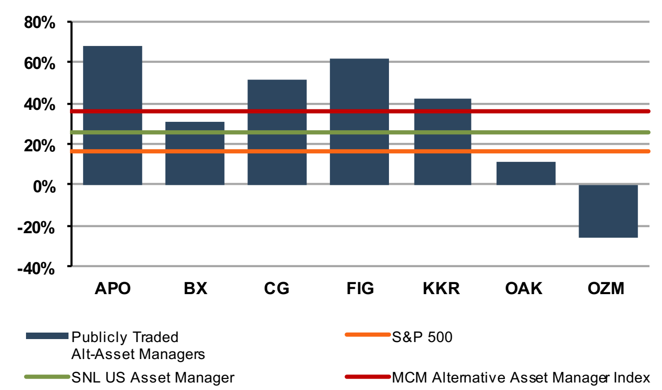
Twelve Months Ended September 30, 2016



Source: S&P Global Market Intelligence

Chart 2: Share Price Performance

Twelve Months Ended September 30, 2017



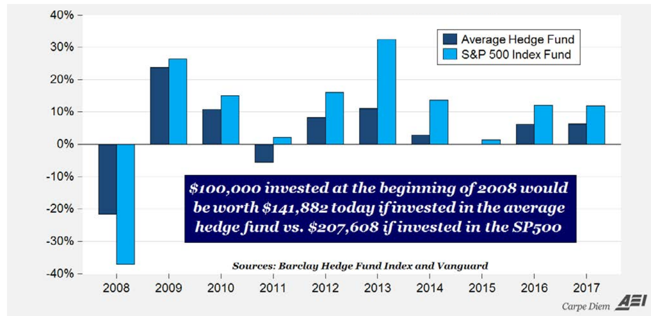
reversed course in recent months. You may attribute this to market schizophrenia, but industry revenue and profitability have **improved on stronger asset flows into active products** earlier this year.

The recent mean reversion therefore appears justified. The outlook remains less certain, though it does appear that the sector's prospects have improved over the last year. Asset flows out of active products seem to have stabilized, and AUM growth has outpaced fee compression in recent quarters. The record low volatility, at least as measured by the VIX gauge, doesn't appear to have slowed down asset gathering or investment returns for most alternative managers.

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 sector is probably justified after a rough 2015 and 2016 for most industry participants.

Chart 3: Average Annual Hedge Fund Returns vs. S&P 500 Index Returns

2008-2016 and 2017 (through August)



Market Overview
Third Quarter 2017

If you only followed the press surrounding asset managers, you'd think the entire industry was in serious trouble. Fee compression, fund outflows, regulatory overhang, rising costs, and a host of other issues have dominated the headlines in recent years, and yet the market doesn't seem to care. RIA stocks continue to climb relatively unabated as the market rally endured another quarter of (fairly) steady gains. This doesn't necessarily mean the press is wrong about some of the problems facing the industry (admittedly, we've blogged about many of them on our blog, ***RIA Valuation Insights***), but it may be missing (or at least not reporting on) the real story – the combination of market appreciation and operating leverage have precipitated significant improvements in profitability since the Financial Crisis, eliciting a favorable response from shareholders.

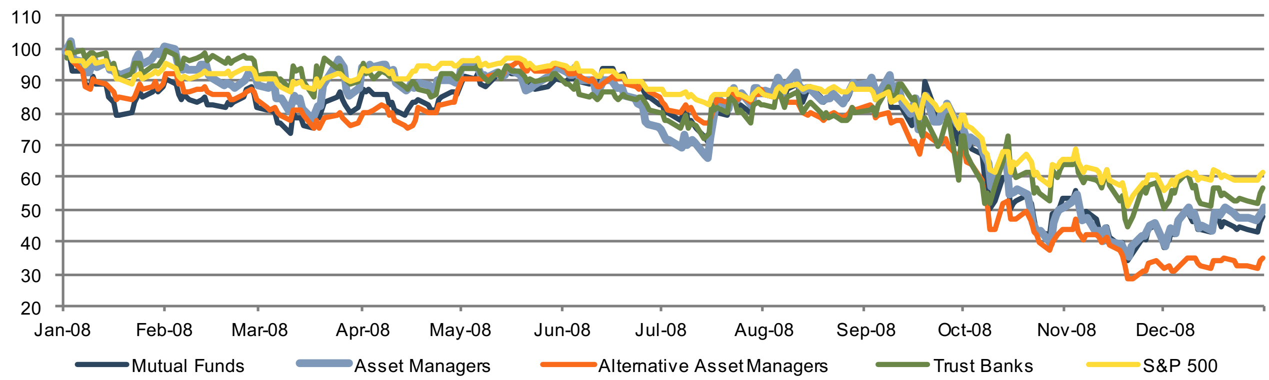
The only problem is that market movements and operating leverage are a double-edged sword. Corrections and bear markets typically lead to more precipitous declines in profitability due to the presence of fixed expenses in most RIA's cost structure. We use 2008 as an example of how the market for RIAs reacts to downturns (Chart 4 on page 3).

Taking a closer look at recent pricing reveals that trust bank stocks have outperformed other classes of asset managers, like mutual funds and traditional RIAs, as passive products and indexing strategies continued to gain ground on active management (Chart 5 on page 3). A rising yield curve portends higher NIM spreads and reinvestment income, and the market has responded accordingly – our custody bank index gained 35% over the last year, surpassing the broader indices and most other classes of asset managers.

Publicly traded alternative asset managers have also performed well in recent quarters, but are still reeling from poor investment returns over the last decade. The value-added proposition (alpha net of fees) has been virtually non-existent for many hedge funds and PE firms over this period despite the sector's recent gains.

Chart 4: Asset Managers Index // Breakdown by Type

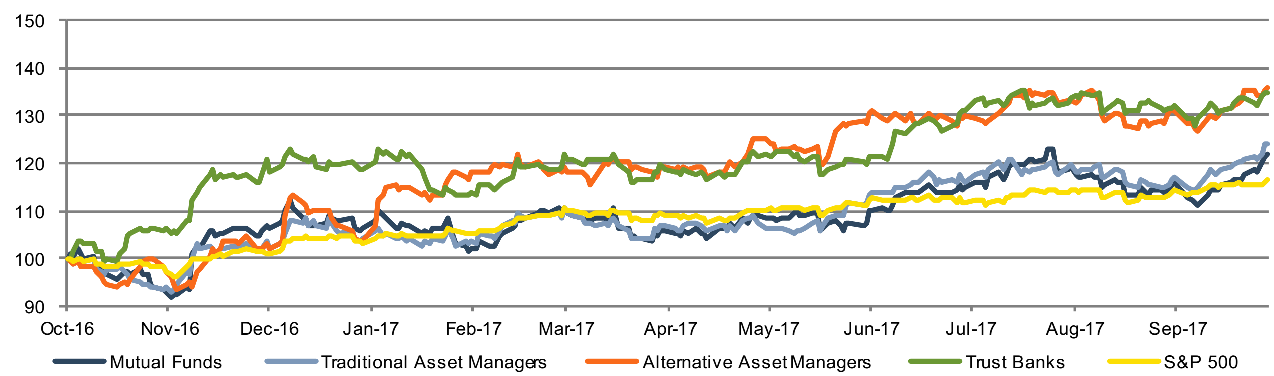
For Year 2008



Source: S&P Global Market Intelligence

Chart 5: Asset Managers Index // Breakdown by Type

For the twelve months ended September 30, 2017



Source: S&P Global Market Intelligence

The RIA size graph seems to imply that smaller RIAs have significantly underperformed their larger peers over the last twelve months (Chart 6 on page 4). The reality, though, is that this segment is the least diversified (only two components, Hennessy Advisors and U.S. Global Investors, both of which are thinly traded) and certainly not a good representation of how RIAs with under $10 billion in AUM are actually performing.

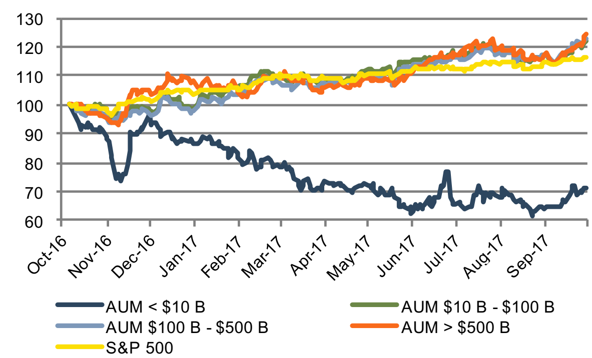
Specifically, Hennessy's weakness is largely attributable to recent sub-par investment performance from its Cornerstone Growth Fund, and U.S. Global's focus on natural resource investing has taken a hit from softening commodity prices.

Most of our clients fall under this size category, and we can definitively say that these businesses (in aggregate) haven't lost half their value since August as suggested by this graph. Publicly traded asset managers of other sizes have slightly outperformed the market over this period.

The outlook for these businesses is similarly 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. Mutual funds and traditional asset managers are more vulnerable to trends in active and passive investing. All are poised for another great year in 2017 as long as the market holds up in the coming months.

Chart 6: Asset Managers Index // Breakdown by Size

For the twelve months ended September 30, 2017



Source: S&P Global Market Intelligence

M&A Review

RIAs have long faced structural headwinds and consolidation pressure from increasing compliance and technology costs, broadly declining fees, and slowing organic growth for many active managers. While these pressures have been compressing margins for years, asset manager 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 for certain firms.

Consolidation pressures appear to have reached critical mass in the last several years, and M&A activity has picked up notably as a result. M&A activity this year is on track to reach its highest level (in terms of deal volume) since 2009.

For publicly traded asset managers, at least, the market seems to view recent M&A activity favorably. Amundi has returned 46% year-to-date (as of October 20) after announcing the acquisition of Pioneer Investments last December. Aberdeen was up 15% through May 31 after agreeing to be acquired by Standard Life in March. KKR shares have risen 20% since April 19, when an investor group led by Stone Point Capital and KKR agreed to buy a majority stake in RIA aggregator Focus Financial Partners.

Recent increases in M&A activity have come against the backdrop of a now eight-year bull market. Steady market gains, particularly in 2017, have more than 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. As a result, profitability has been steadily increasing despite industry headwinds that seem to rationalize consolidation.

It is unclear whether this positive market movement has been a boon or a bane to M&A activity. On one hand, many asset managers may see rapid AUM gains from market movement as a case of easy come, easy go. In that case, better to sell sooner rather than later. And vice versa from a buyer's perspective. On the other hand, as long as markets trend upwards, margin and fee pressures are easy to ignore. In that case, a protracted market downturn could lead to a shakeout for firms with cost structures that are unsustainable without the aid of a bull market.

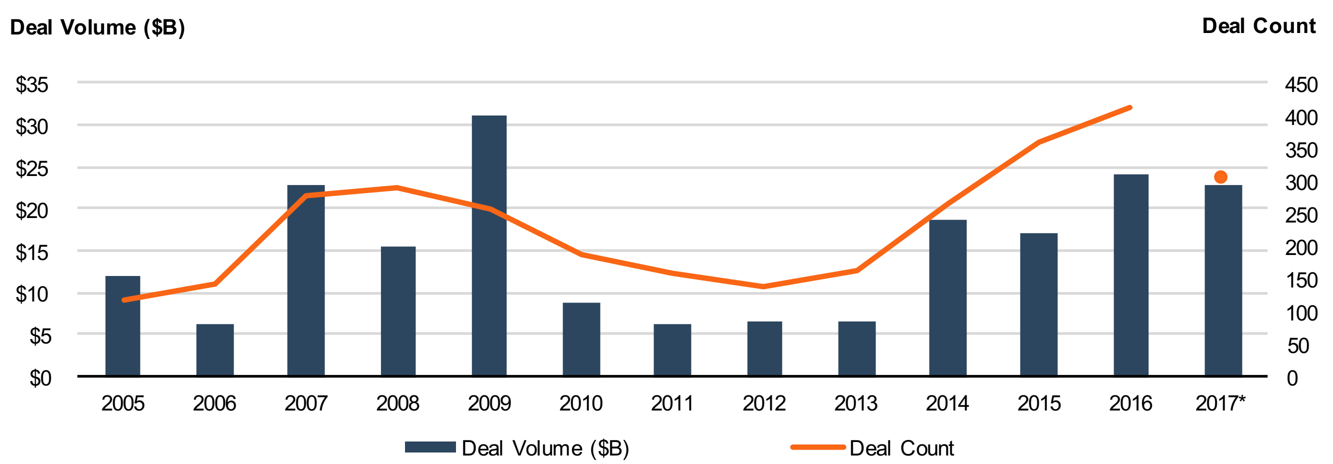
We saw the effect a market downturn can have on M&A activity during 2009, when deal volume reached record levels as many distressed firms were sold. The M&A activity spurred by the 2009 downturn was short lived, however. Deal volume was largely subdued between 2010 and 2013. The fallow period ended in 2014, and deal activity has since accelerated while broad market indices have marched higher.

It seems likely that asset manager deal activity will continue to gain speed regardless of which way the markets are moving, although a market downturn could certainly expedite consolidation. Asset managers face secular trends that threaten lower revenue and higher costs. On the top line side, assets continue to flow into low fee passive funds at a good clip. On the cost side, an evolving regulatory environment threatens increasing compliance costs. Consolidation allows asset managers to spread compliance costs over a larger AUM base and increase distribution channels and product offerings, thereby combating revenue and cost pressure.

But if a protracted bear market does materialize, margins will face pressure not only from the evolving industry dynamics but also from evaporating AUM. A significant market downturn may highlight the consolidation pressures in the industry and catalyze a larger wave of M&A activity.

Chart 7: Asset Manager M&A

2005-2017



Source: Bloomberg
**2017 through 10/20/2017*
Includes international transactions

Asset Manager Multiples by Sector

				Pricing as of September 30, 2017			
	Ticker	9/30/2017 Stock Price	% of 52 Week High	Price / Trailing EPS	Price / Forward EPS	Total Capital / AUM (%)	Total Capital / EBITDA
TRADITIONAL ASSET MANAGERS							
Affiliated Managers Group, Inc.	AMG	$189.83	98.88%	11.1x	11.8x	1.87	16.1x
BlackRock, Inc.	BLK	$447.09	99.68%	22.1x	20.5x	1.33	13.8x
Legg Mason, Inc.	LM	$39.31	93.42%	15.4x	17.6x	0.74	10.2x
Pzena Investment Management, Inc.	PZN	$10.89	94.22%	23.9x	18.8x	2.34	11.6x
Westwood Holdings Group, Inc.	WHG	$67.27	98.23%	21.0x	nm	2.53	13.5x
Group Median			**98.23%**	**21.0x**	**18.2x**	**1.87**	**13.5x**
MUTUAL FUNDS							
AllianceBerstein Investments, Inc.	AB	$24.30	94.80%	11.1x	11.8x	0.45	nm
Cohen & Steers, Inc.	CNS	$39.49	92.54%	19.3x	19.6x	2.73	10.5x
INVESCO Ltd.	IVZ	$35.04	95.95%	16.1x	13.8x	1.75	10.6x
Franklin Resources, Inc.	BEN	$44.51	93.83%	14.6x	15.1x	2.37	7.2x
Diamond Hill Investment Group, Inc.	DHIL	$212.35	98.42%	17.2x	nm	3.40	8.0x
Eaton Vance Corp.	EV	$49.37	99.06%	21.5x	20.1x	nm	12.0x
Hennessy Advisors, Inc,	HNNA	$15.44	64.84%	8.0x	nm	2.02	5.4x
Manning & Napier, Inc.	MN	$3.95	51.10%	7.5x	8.7x	0.00	0.0x
T. Rowe Price Group, Inc.	TROW	$90.65	99.41%	17.7x	17.0x	2.41	9.4x
U.S. Global Investors, Inc.	GROW	$2.13	88.75%	54.7x	nm	3.33	nm
Waddell & Reed Financial, Inc.	WDR	$20.07	94.67%	11.8x	13.5x	1.74	6.0x
Federated Investors, Inc.	FII	$29.70	98.90%	14.6x	14.5x	0.85	8.5x
Virtus Investment Partners, Inc.	VRTS	$116.05	91.69%	13.1x	15.3x	4.21	32.0x
Group Median			**94.67%**	**14.6x**	**14.8x**	**2.19**	**8.5x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, LLC	APO	$30.10	94.98%	13.17x	12.28x	3.42	5.99x
Blackstone Group L.P.	BX	$33.37	96.61%	18.08x	11.90x	13.47	13.25x
Carlyle Group, L.P,	CG	$23.60	95.55%	15.15x	8.38x	3.89	5.96x
Fortress Investment Group LLC	FIG	$7.97	99.01%	24.11x	9.54x	4.12	9.77x
Kohlberg Kravis Roberts & Co.	KKR	$20.33	99.51%	8.44x	7.76x	19.56	nm
Oaktree Capital Group, LLC	OAK	$47.05	98.23%	10.26x	12.10x	10.86	10.81x
Och-Ziff Capital Mgmt Group LLC	OZM	$3.22	70.97%	54.39x	5.85x	5.08	16.06x
Group Median			**96.61%**	**15.15x**	**9.54x**	**5.08**	**10.29x**
TRUST BANKS							
Northern Trust Corporation	NTRS	$91.93	93.02%	20.5x	19.6x	nm	nm
Bank of New York Mellon Corporation	BK	$53.02	97.57%	15.6x	15.0x	0.11	nm
State Street Corporation	STT	$95.54	99.55%	16.6x	15.5x	nm	nm
Group Median			**97.57%**	**16.6x**	**15.5x**	**nm**	**nm**
OVERALL MEDIAN			**95.75%**	**15.8x**	**14.1x**	**2.41**	**10.3x**

Data Source: S&P Global Market Intelligence

5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137

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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, 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.

Matt Crow, ASA, CFA
President
901.322.9728
crowm@mercercapital.com

Brooks Hamner, CFA, ASA
Vice President
901.322.9714
hamnerb@mercercapital.com

Zachary W. Milam
Financial Analyst
901.322.9705
milamz@mercercapital.com

www.mercercapital.com

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