VALUE FOCUS
Asset Management Industry

SEGMENT FOCUS
Trust Banks

2017

Q1: Mutual Funds
Q2: Traditional Asset Managers
Q3: Alternative Asset Managers
Q4: Trust Banks

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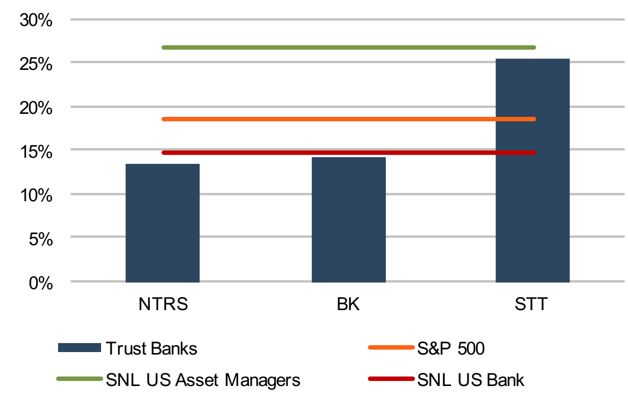
Segment Focus
Trust Banks

All three publicly traded trust banks (BNY Mellon, State Street, and Northern Trust) underperformed other categories of asset managers during 2017, and only State Street outperformed the S&P 500 (Chart 1). While all three benefited from growth in Assets Under Custody and Administration and AUM due to strong equity markets in 2017, the trust banks performed more in line with U.S. banks generally during 2017. The exception is State Street, which performed comparably to the SNL Asset Manager Index due in part to its outsized ETF business (State Street is one of the three largest ETF providers globally). The other two trust banks have less significant ETF business (Northern Trust) or none at all (BNY Mellon).

Throughout 2017, trust banks tended to underperform other classes of asset managers like alternative asset managers, mutual funds, and traditional asset managers (Chart 2). To put this in historical context, trust banks have lagged the broader indices since the financial crisis of 2008 and 2009 (though 2016 was a record year for most of these businesses). With the exception of trust banks, all classes of asset managers outperformed the S&P 500, as rising equity markets and operating leverage combined to increase the profitability of these businesses.

Despite the relative underperformance during 2017, trust banks saw increases in their two largest sources of fee revenue (servicing and investment management fees) due primarily to strengthening equity markets. Trust banks also saw improved net interest margins due to higher U.S. market interest rates. Trading services revenues, which are a less significant component of fee revenue than servicing and management fees, were generally down in 2017 due to low volatility in the equity markets. Trust bank trailing multiples have expanded in line with other categories of asset managers since last year, so their underperformance suggests that earnings haven't kept pace (see "Asset Manager Multiples by Sector" on page 4).

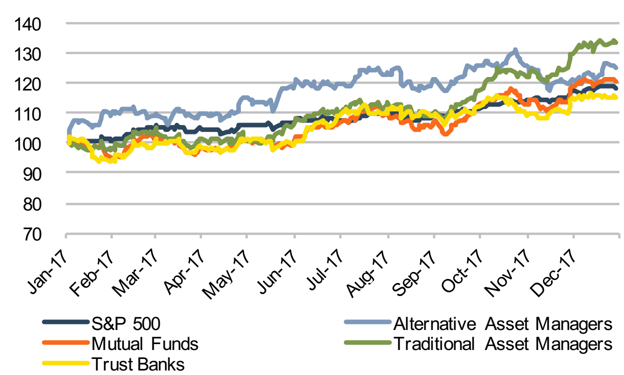
Chart 1: 2017 Trust Bank Returns



Source: S&P Global Market Intelligence

Chart 2: Asset Management Performance in 2017

By Sector



Source: S&P Global Market Intelligence

So have these securities gone from overbought to oversold? A quick glance at year end pricing shows the group valued at 14-16x (forward and trailing) earnings with the rest of the market closer to 25x, so that alone would suggest that they aren't too aggressively priced. Still, the three companies are all trading near 52 week highs, so it's hard to say they're really all that cheap either.

Sector Analysis
2017 in Review

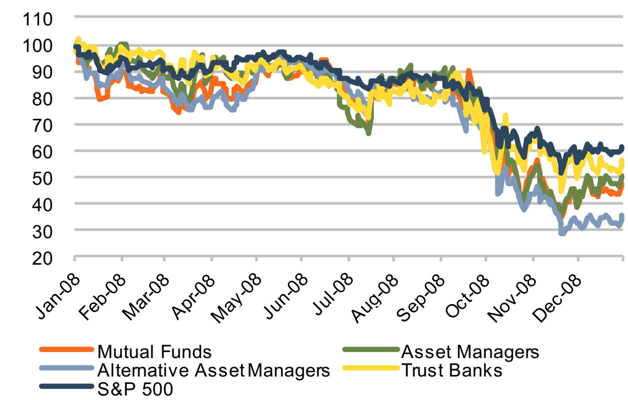
Favorable market conditions over the last year have lifted RIA market caps to all-time highs yet again as AUM balances continue to climb with the major indices (Chart 2 on page 1). Market gains have apparently trumped fee compression, fund outflows, regulatory overhang, rising costs, and a host of other industry headwinds that have dominated the headlines in recent years. 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 ***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 investors despite everything we've been reading (and writing) about the industry.

The only problem is that market movements and operating leverage are a double-edged sword. Upward or downward trends in the broader market tend to have a magnified effect on the stock prices of asset managers. While 2017 has been a great year for the S&P 500 and an even better year for most categories of RIAs, the reverse can also be true: a bad year for the market can mean an even worse year for asset managers. Historically, corrections and bear markets have led to more precipitous declines in profitability due to the presence of fixed expenses in most RIAs' capital structures. We use 2008 as an example of how the market for asset manager stocks reacts to downturns (Chart 3).

Traditional asset managers ended the year up 33%, outperforming the S&P 500 and most other categories of asset managers (Chart 2). Publicly traded alternative asset managers also performed well during 2017, although most of the sector's gains occurred during the first half of the year. Alternative asset managers 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

Chart 3: Asset Management Performance

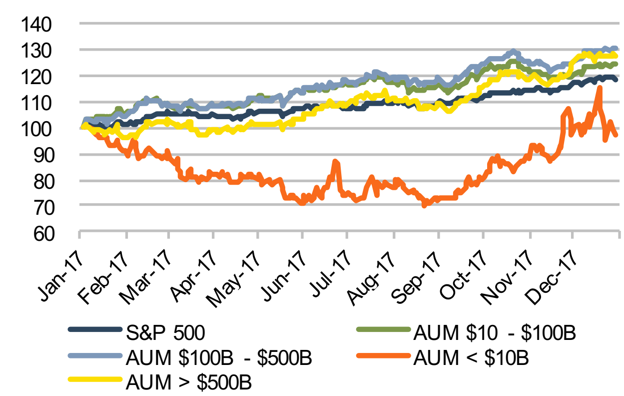
For 2008



Source: S&P Global Market Intelligence

Chart 4: Asset Management Performance in 2017

By Size



Source: S&P Global Market Intelligence

hedge funds and PE firms over this period, despite the sector's recent gains.

The RIA size graph (Chart 4) seems to imply that smaller RIAs have bounced back in the fourth quarter after being down nearly 30% at the end of the third quarter. The reality, though, is that this segment is the least diversified (only two components, Hennessy Advisors and US 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 has performed poorly throughout 2017 due in part to recent sub-par investment performance from its Cornerstone Growth Fund. Hennessey's poor performance was more than offset by U.S. Global Investors, which was up nearly 100% in the fourth quarter alone due to its strategic investment in HIVE Blockchain Technologies, a company which mines bitcoin (although **just having blockchain in the name** likely would have been enough). While most of our clients fall under this size category, we can definitively say that these businesses (in aggregate) haven't followed the pricing trends suggested by this graph. Other sizes of publicly traded asset managers have all outperformed the market over this period, with the $100–$500 billion AUM group seeing the largest gains.

M&A Review

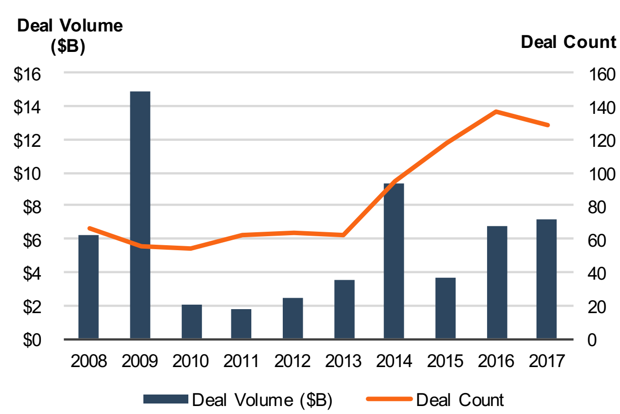
Recent increases in M&A activity come against a backdrop of a now nine-year-old bull market. Steady market gains have continued throughout 2017 and have more than offset the consistent and significant negative AUM outflows that many active managers have seen over the past several years. In 2016, for example, assets in active mutual funds grew to $11 trillion from $10.7 trillion, despite $400 billion in net outflows according to data from *Bloomberg*. As a result of increasing AUM and concomitant revenue growth, profitability has been steadily rising 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 not sustainable without the aid of a bull market (as was the case in 2008 and 2009).

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 in 2018, though a protracted bear market, should it materialize, could highlight consolidation pressures and provide a catalyst for a larger wave of M&A activity. 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, which could further facilitate the upward M&A trend into 2018.

Chart 5: Asset Manager M&A Activity

2008–2017



Asset Manager Multiples by Sector

				Pricing as of December 31, 2017			
	Ticker	12/31/2017 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	$205.25	98.8%	11.8x	10.7x	1.92	16.3x
BlackRock, Inc.	BLK	$513.71	98.6%	24.5x	20.0x	1.47	15.1x
Legg Mason, Inc.	LM	$41.98	98.9%	15.8x	12.6x	0.74	9.9x
Pzena Investment Management, Inc.	PZN	$10.67	84.2%	21.8x	12.3x	2.10	10.2x
Westwood Holdings Group, Inc.	WHG	$66.21	94.2%	20.2x	nm	2.39	14.2x
Group Median			**98.6%**	**20.2x**	**12.4x**	**1.92**	**14.2x**
MUTUAL FUNDS							
AllianceBerstein Investments, Inc.	AB	$25.05	95.8%	11.8x	10.7x	0.46	nm
Cohen & Steers, Inc.	CNS	$47.29	98.9%	23.0x	20.0x	3.35	12.3x
INVESCO Ltd.	IVZ	$36.54	96.5%	16.0x	12.5x	2.26	13.6x
Franklin Resources, Inc.	BEN	$43.33	91.8%	14.5x	14.7x	2.23	6.8x
Diamond Hill Investment Group, Inc.	DHIL	$206.66	96.6%	16.2x	nm	3.07	7.7x
Eaton Vance Corp.	EV	$56.39	97.7%	23.4x	18.3x	nm	13.1x
Hennessy Advisors, Inc,	HNNA	$16.54	78.0%	8.6x	nm	2.10	5.7x
Manning & Napier, Inc.	MN	$3.60	47.5%	9.0x	10.5x	nm	-0.3x
T. Rowe Price Group, Inc.	TROW	$104.93	98.9%	19.5x	17.5x	2.68	10.3x
U.S. Global Investors, Inc.	GROW	$3.90	52.1%	43.3x	nm	7.11	nm
Waddell & Reed Financial, Inc.	WDR	$22.34	97.6%	15.0x	13.2x	2.26	8.2x
Federated Investors, Inc.	FII	$36.08	98.4%	17.5x	15.8x	1.00	10.1x
Virtus Investment Partners, Inc.	VRTS	$115.05	92.3%	13.1x	11.4x	4.06	27.4x
Group Median			**96.5%**	**16.0x**	**14.0x**	**2.26**	**10.1x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, LLC	APO	$33.47	98.4%	12.2x	11.1x	3.74	6.0x
Blackstone Group L.P.	BX	$32.02	92.5%	16.5x	10.3x	13.14	12.9x
Carlyle Group, L.P,	CG	$22.90	94.6%	12.4x	9.3x	3.73	4.7x
Kohlberg Kravis Roberts & Co.	KKR	$21.06	98.4%	10.6x	8.6x	20.02	nm
Oaktree Capital Group, LLC	OAK	$42.10	88.7%	9.7x	11.4x	10.18	10.5x
Och-Ziff Capital Mgmt Group LLC	OZM	$2.50	63.7%	208.3x	7.0x	4.35	18.1x
Group Median			**93.6%**	**12.3x**	**9.8x**	**7.26x**	**10.5x**
TRUST BANKS							
Northern Trust Corporation	NTRS	$99.89	98.5%	21.7x	17.8x	nm	nm
Bank of New York Mellon Corporation	BK	$53.86	97.2%	15.7x	13.4x	0.05	nm
State Street Corporation	STT	$97.61	97.2%	16.1x	13.7x	nm	nm
Group Median			**97.2%**	**16.1x**	**13.7x**	**0.05**	**nm**
OVERALL MEDIAN			**96.6%**	**16.0x**	**12.5x**	**2.39**	**10.3x**

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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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