VALUE FOCUS

Investment Management

First Quarter 2020 | Segment Focus: Asset Managers

In This Issue

In this issue, we review public market performance across the investment management industry in light of the COVID-19 global pandemic. During the first quarter of 2020, the global economy was affected by a pandemic declared by the World Health Organization involving the novel coronavirus ("COVID-19"). As of March 31, 2020, the S&P 500 had fallen by 20% since the beginning of the year, and publicly traded RIAs suffered their worst quarter since the financial crisis. Pre-COVID-19, the industry was already facing numerous headwinds including fee pressure, asset outflows, and the rising popularity of passive investment products. The 11-year bull market run masked these issues (at least ostensibly) as AUM balances largely rose with equities over this time. Finally faced with a market headwind, the bull market for the RIA industry came to a grinding halt in Q1 2020.

In our segment focus for this quarter, we look at asset managers' underperformance over the last decade, which has driven outflows to passive products. Now is a critical time for these businesses to deliver on their value proposition of alpha net of fees. However, outflows for active funds have accelerated as the global pandemic has caused investors to rapidly shift into cash. The combination of accelerating outflows and falling asset prices represents a major headwind for active asset managers, and the price movement in publicly traded asset managers has reflected this.

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. In Q1 2020, the M&A environment changed rapidly. While we do not expect deals that are in the final stages of negotiations to be canceled, we do expect there to be a slowdown in new deal activity in 2020 as firm principals, RIA consolidators, and outside investors try to conserve capital and project the length of the downturn and the associated impact on RIA revenues and profit.

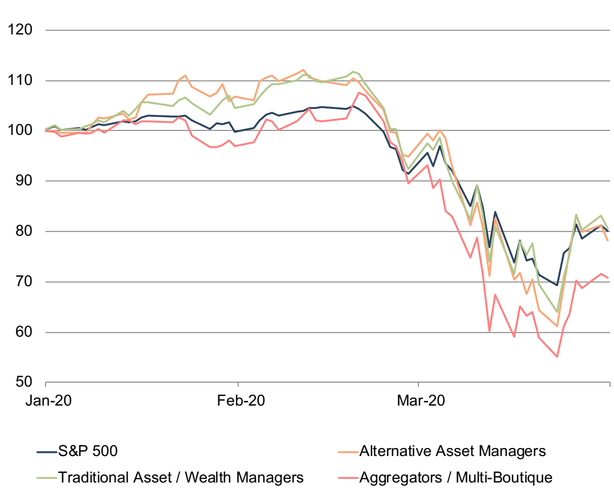
RIAs Suffer Worst Quarter Since the Financial Crisis

Most Ria Stocks Are Now In Bear Market Territory

Last quarter we wrote about **how great 2019 was** for the RIA industry. Recent events have rendered that post largely irrelevant, as recent discussions in the industry are now centered on how the COVID-19 global pandemic has impaired RIA valuations.

The chart below shows there was nowhere to hide last quarter, as all four components of the RIA industry dipped into bear market territory during the quarter. The primary driver behind the decline was the decline in the market itself, as most of these businesses are primarily invested in equities, and the S&P was down 20% over the quarter. The aggregators are down a bit more since their models rely on debt financing, which exacerbates losses during times of financial strain.

Investment Management Performance by Sector: Q1 2020

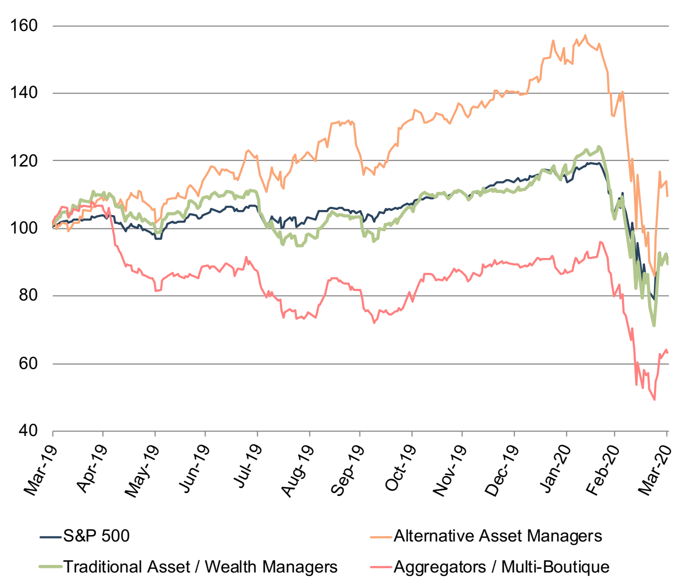


Source: S&P Global Market Intelligence

Pre-COVID, the industry was already facing numerous headwinds including fee pressure, asset outflows, and the rising popularity of passive investment products. The 11-year bull market run masked these issues (at least ostensibly) as AUM balances largely rose with equities over this time. Finally faced with a market headwind, the bull market for the RIA industry came to a grinding halt last month.

Regardless, this bear market has to be placed in proper context. It's hard to believe, but the industry (excluding the consolidators) is pretty much right where it was a year ago in terms of market caps. We basically just gave up the gains made in the back half of last year though the decline was far more rapid.

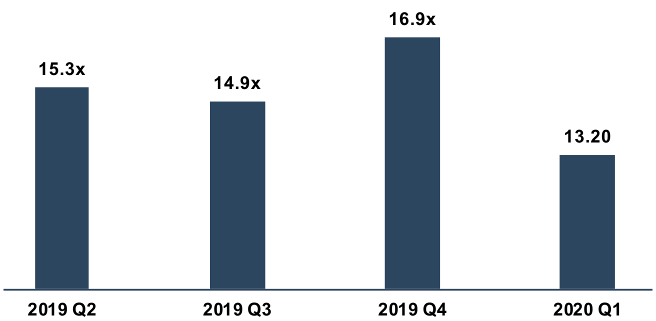
Investment Management Performance by Sector: Twelve Months Ended March 31, 2020



Source: S&P Global Market Intelligence

As valuation analysts, we're typically more concerned with how earnings multiples have changed over this time since we often apply these cap factors to our subject company's profitability metrics (after any necessary adjustments) to derive an indicated value. These multiples show a similar decline in Q1 after a sizeable increase in the four quarter of last year.

Price to LTM EPS for Traditional Asset / Wealth Managers



There are a number of explanations for this variation. Earnings multiples are primarily a function of risk and growth, and risk has undoubtedly risen in the last couple of months while growth prospects have diminished. Specifically, future earnings are likely to decline with AUM and revenue, so the multiple has pulled back accordingly. Conversely, the run-up in Q4 reflected the market's anticipation of higher earnings with rising AUM and management fees. The multiple usually follows ongoing revenue, which is simply a **function of current AUM and effective fee percentages.**

Implications for Your RIA

Year-to-date, the value of your RIA is most likely down; the question is how much. Some of our clients are asking us to update our year-end appraisals to reflect the current market conditions. There are several factors we look at in determining an appropriate level of impairment.

One is the overall market for RIA stocks, which is down 20% in the first quarter (see chart above). The P/E multiple is another reference point, which has declined 22% so far this year. We apply this multiple to a subject RIA's earnings, so we also have to assess how much that company's annual AUM, revenue, and cash flow have diminished over the quarter, while being careful not to count bad news twice.

We also evaluate how our subject company is performing relative to the industry as a whole. Fixed income managers, for instance, have held up reasonably well compared to their equity counterparts. We also look at how much a subject company's change in AUM is due to market conditions versus new business development net of lost accounts. Investment performance and the pipeline for new customers are also key differentiators that we keep a close eye on.

Diminishing 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 has generally diminished with market conditions over the last couple of months. AUM is down with the market, and it's likely that industry-wide revenue and earnings declined with it. April has been kinder, but volatility remains.

If the bid-ask spread between you and your partners has been too high to get a deal done, it may time to re-examine your price expectations. The next generation of ownership may be enticed by more attractive valuations and return to the negotiating table, so knowing your firm's worth may be more important than ever.

Segment Focus: Asset Managers

Falling Asset Prices Threaten Profitability as Spotlight Turns to Relative Performance

The recent sell-off in equities will put pressure on the financial performance of most asset managers, given that revenues and cash flows are highly correlated with the market. At the same time, it is also a critical time for these businesses to deliver on their value proposition of alpha net of fees. Active managers have generally underperformed their benchmarks over the past 10 years, which has driven outflows into low-fee passive products. The extreme financial market volatility and dispersion over the last two months has created major price dislocation and the potential to generate outperformance. The current environment may well be the time for active managers to prove themselves by protecting clients' assets relative to index performance and justifying their fees.

Underperformance has Driven Outflows

For active managers, the eleven-year bull run that preceded the current downturn was accompanied by relative underperformance, falling fees, and asset outflows. Over the last decade, indexing to the market largely beat out stock picking and asset allocation based on security-specific research or macroeconomic factors. The strong performance of large cap indices like the S&P 500 between the 2008-2009 recession and February of this year has been largely driven by a handful of sizeable tech companies, and active managers struggled to deliver alpha in that environment. Not only did the indices beat the active managers, the fees on the passive products tracking these indices have fallen to virtually zero. Not surprisingly, investors have chased after the strong relative performance and low fees of passive index tracking products. In August of last year, the amount of passively invested assets exceeded their actively managed counterparts for the first time ever.

Many asset managers have explained underperformance over the last decade in the context of a runaway bull market while suggesting that the merits of active management would be proven in the next downturn. So, now that a bear market and significant volatility are here, will active managers outperform? Intuitively, it makes some sense, as market shocks and liquidity needs in a downturn can cause disconnects between asset prices and fundamentals that active managers seek to exploit. There is some evidence to suggest that active/passive relative performance is cyclical. The 10-year bull market through 2019 was accompanied by passively managed funds outperforming. With the bull market over, the era of passive outperformance may be as well.

However, the initial data from **Morningstar** indicates that only about 42% of active funds beat their indices between February 20, 2020 and March 16, 2020, compared to 44% during the preceding rally (December 24, 2018 – February 19, 2020). While active funds collectively have not fared well, some asset classes have fared better than others. Some alternatives, commodities, and sector equity funds have outperformed by wide margins during the bear market. Funds with long-short exposure or large cash holdings relative to the benchmark have also had high success rates.

Outflows from Active Funds Accelerate

Outflows for active funds have accelerated as the global pandemic has caused investors to rapidly shift into cash. March saw record outflows from long-term funds and record inflows into money market funds. The outflows in long-term funds were concentrated in actively managed funds. Passively managed U.S. equity funds saw $41 billion in net inflows in March, while all categories of actively managed funds saw outflows in March.

Stock Price Performance for Publicly Traded Asset Managers

The combination of accelerating outflows and falling asset prices represents a major headwind for active asset managers, and the price movement in publicly traded asset managers has reflected this. As shown in the pricing chart at the end of this newsletter, the stock prices for most of these companies represented approximately 55% to 60% of their 52-week highs.

Only Legg Mason and BlackRock pricing at March 31, 2020 represented more than 75% of its 52 week high, and the performance of Legg Mason is not related to its fundamentals, but rather a fortuitously timed transaction. Franklin Resources agreed to buy Legg Mason for $50.00 cash per share on February 18, 2020, one day before the S&P reached its peak. Since then, Legg's shares have been anchored close to $50.00, while Franklin Resources' price has fallen significantly as it is stuck on the other side of a trade that now looks very good for Legg Mason shareholders.

BlackRock, on the other hand, has performed well due to its positioning as the largest player in passive products. About 75% of BlackRock's $7.4 trillion in assets under management are passively managed, and its growth has been driven not just by market movement but by strong inflows into its iShares ETF franchise and other passive products. The strong relative performance of BlackRock's shares in this environment suggests that the market views BlackRock and its massive passive franchise as better positioned to perform than its smaller, more actively managed counterparts.

Outlook for Future Financial Performance

Moody's recently downgraded its outlook on global asset managers to "negative" from "stable", citing economic headwinds and market declines resulting from the coronavirus pandemic. With asset prices down virtually across the board, asset management revenues and profitability will take a significant hit in the second quarter and perhaps beyond depending on the market trajectory. The financial performance of asset management firms over the next several years will largely be tied to the shape of the market recovery.

The longer-term outlook for active managers depends more on the ability of these managers to deliver alpha net of fees in the current environment and stem the asset outflows that have drained AUM over the last decade. While the initial data indicates that active management relative performance has not improved during the bear market, there is opportunity over the next several months as markets calm and prices reconnect with fundamentals. The coming months will be a critical time for asset managers to prove themselves.

RIA M&A: Down But Not Out

The outlook for RIA M&A has changed rapidly since 2020 began. Coming off of a record year, DeVoe postulated in January that "RIA **M&A could hit over 40 transactions per quarter** in 2020" saying that "the pace of deals was a testament to the health of the industry." Until late February, DeVoe's estimation seemed feasible as industry experts contemplated what the Franklin / Legg Mason deal and Morgan Stanley's purchase of E-Trade meant for the industry, and we wrote about **Creative Planning's sale of a minority interest to PE firm General Atlantic.**

Today, however, as many of us work from makeshift home-offices, RIA principals have shifted their focus from strategic planning including M&A, to ensuring their workforce is safe and healthy, their client service is unwavering, and their firm still exists on the other side of this bear market.

In this article we look back at RIA transactions that occurred in Q1 2020 and venture what M&A will look like over the rest of the year.

Review of M&A in Q1 2020

According to **Fidelity Investments**, there were thirteen deals between wealth managers in January, totaling $18.9 billion in client assets. The largest of these deals by AUM was Fiduciary Trust Company's acquisition of Athena Capital, which has $5.8 billion of AUM. This deal pales in comparison to Fiduciary Trust Company's parent, Franklin Templeton's, acquisition of Legg Mason (LM), with $1.5 trillion in AUM, for approximately $4.5 billion. These two deals highlight the differing motivations driving transactions in the RIA space.

Fiduciary Trust Company's acquisition of Athena allowed the company to strengthen its foothold in New England, where it already has about $2 billion in client assets. Many RIA's seeking to grow geographically have turned to acquisitions rather than growing organically. Since wealth management is a relationship driven business, partnering with those who already have relationships in a target market is often a faster growth strategy than building these relationships in new markets on your own. Additionally, Fiduciary Trust Company's acquisition expanded its product offerings for high net worth and ultra-high net worth clients.

The Franklin / LM deal highlights one of the biggest drivers of M&A in the investment management space: achieving scale. There is significant operating leverage in the asset management business, and the Franklin / LM combination created a $1.5 trillion money manager poised to take advantage of this. While management of both companies asserted that there would be no personnel changes after the deal was finalized, back office synergies will likely lead to cost savings that will increase returns to investors.

Additionally, in the first quarter of 2020 we continued to see deals driven by RIA consolidators such as Focus Financial and Beacon Pointe who are able to provide scale through back office integration and a solution for ownership succession planning.

Outlook for RIA M&A

By the end of the first quarter, the tone of discussions in the industry had changed. As of March 31, 2020, the S&P 500 had fallen by 20% since the beginning of the year, and publicly traded RIAs suffered their worst quarter since the financial crisis. The **outlook for RIAs depends on a number of factors**, but the one commonality is that RIAs are all impacted by the market. The decline in the market, and in turn, in RIAs' revenue has led industry commentators to ponder the likely impact on deal volume and valuations.

Pace of M&A Activity

After thirteen wealth manager deals were announced in January, activity slowed with seven deals in February and three deals in March 2020. Although, deals become riskier in volatile and bear markets, they don't happen overnight. The deals that closed in March were likely being negotiated in November and December of 2019. Given the lag between deal negotiations and singing/closing of a transaction, it's likely that the decline in deal volume from January to March doesn't fully reflect the new market reality.

While we do not expect deals that are in the final stages of negotiations to be canceled, we do expect there to be a slowdown in new deal activity in 2020 as firm principals, RIA consolidators, and outside investors try to conserve capital and project the length of the downturn and the associated impact on RIA revenues and profit.

Historically, recessions have corresponded with lower deal volume. According to McKinsey, "Since 1980, **U.S. recessions have led to steep declines in the value of global M&A** activity—typically, of around 50 percent during the first year." We saw this in 2008 as deal activity slowed at the start of the last recession. However, it is important to recognize the limitations of comparing the current market downturn to the last recession, which was caused in part by excess leverage and a lack of regulation in the financial industry. Credit markets essentially collapsed and funding for M&A was suddenly much harder to come by. While financial markets are currently suffering, markets are not down because of blemishes within our financial systems.

Deal activity in the RIA industry during this market downturn could be propped up by the recent expansion of available capital in the space. M&A volume has increased in recent years as RIAs have gained more access to capital, both **equity** and **debt**. It is still too early to know if access to capital will decline. A recent article by Financial Planning predicts that **PE money will not dry up**. Rather, Echelon founder Dan Sievert believes, PE funding is "going to save the industry." He predicts PE investors will continue to invest in RIAs and "[S]woop up any companies that are falling on hard times."

There may still be some difficulty finding financing for very large transactions. In 2008, **not a single "mega-deal" (value of over $10 billion) was announced.** Understanding that "mega-deals" within the RIA space may be defined slightly differently, we still expect there to be a slowdown in larger deals, of which we saw many over the last twelve months. Further, consolidators may reduce the size of their typical transaction as financing for these smaller deals is easier to come by, and a multitude of smaller deals instead of singular larger deals can serve as a means to diversify risk in this volatile operating environment.

You Name The Price, I'll Name The Terms

While deal multiples may not fall, we do expect deal structures to change.

The **RIA Deal Room**, published by Advisor Growth Strategies before the COVID-19 pandemic, recently asked if "valuations [were] rising due to better financial results, expanded multiples, or both?" They found that "*the data suggest that valuations increased for 90% of RIA firms due to sustained financial performance. […] From 2015 – 2018, the median adjusted EBITDA multiple was 5.1, and there was less than 10% positive or negative variation in the yearly median results.*"

A decline in announced deal value in 2020 will likely come as a result of a decline in performance driven by an overall decline in the market, rather than a decline in deal multiples. As **Matt Crow explained in a recent podcast**, we don't expect multiples to decline drastically. Instead, we expect that deals will be structured to more evenly distribute risk between the buyer and the seller through the use of earnouts.

More than **70% of RIA transactions** in 2019 were structured with some form of an earnout and, on average, sellers paid 30% of total deal proceeds as an earnout. Of those deals structured with an earnout, the payments were typically made over three years or less. Given the new uncertain operating environment for RIAs, we expect that more deals will involve some form of contingent consideration and less of the deal consideration will be paid at closing.

Additionally, given the current volatility, we expect there will be an increase in the number of deals structured as stock deals. In a volatile operating environment, it can be easier to close a stock deal since the price (value of the shares) essentially moves as the market does.

Conclusion

In summary, we expect that deal volume will slow over the next few months, but as **Think Advisor** recently noted, this slowdown is not necessarily bad news for the industry. During the slowdown *"RIAs should take the opportunity to consider how M&A efforts perpetuate the broader objectives of an advisory firm."*

Although we expect activity to slow, M&A activity will not come to a grinding halt. Owners of RIAs who find themselves near retirement and without a succession plan will still consider selling their firm. Additionally, the need for operating leverage that is achievable through scale becomes more pronounced in bear markets.

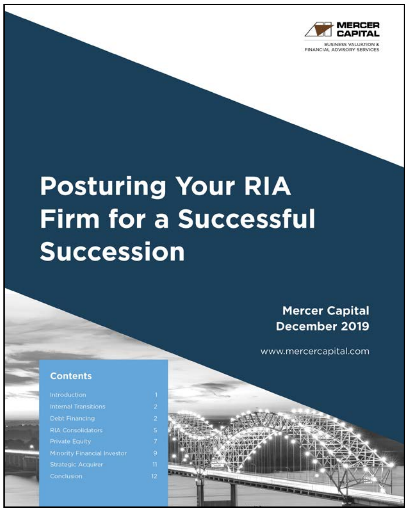
The less leveraged RIA consolidators are uniquely positioned to partner with RIAs in bear markets as they are able to offer more operating leverage through back office infrastructure. Additionally, as these consolidators are often PE backed, they should still be able to find funding in a bear market.

RIA Whitepapers

This whitepaper is intended to give a brief overview of relevant considerations of perspectives on the expected returns on the value of trust companies.

DOWNLOAD

or visit https://mer.cr/381XxxK



A whitepaper outlining the viable options for RIA principals looking to exit the business.

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or visit https://mer.cr/2k2ouwK

Investment Manager Multiples by Sector

				Pricing as of March. 31, 2020			
	Ticker	3/31/2020 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	90.24	61.8%	10.0x	nm	0.95	2.7x
GAMCO Investors, Inc.	GBL	10.99	48.4%	3.5x	nm	0.67	2.1x
Hennessy Advisors, Inc,	HNNA	7.59	60.8%	5.5x	nm	1.03	3.3x
Pzena Investment Management, Inc.	PZN	4.46	45.6%	8.9x	nm	0.86	6.9x
Silvercrest Asset Management Group	SAMG	9.46	64.5%	8.2x	6.8x	1.00	6.1x
Westwood Holdings Group, Inc.	WHG	18.31	53.2%	24.8x	nm	0.80	11.9x
Group Median			**57.0%**	**8.5x**	**6.8x**	**0.90**	**4.7x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $100B)							
AllianceBerstein Investments, Inc.	AB	18.59	52.8%	7.5x	8.0x	0.89	nm
BlackRock, Inc.	BLK	439.97	76.9%	16.4x	17.1x	1.09	11.1x
Eaton Vance Corp.	EV	32.25	62.3%	9.3x	11.3x	1.09	9.6x
Federated Investors, Inc.	FHI	19.05	50.2%	7.1x	8.2x	0.37	5.3x
Franklin Resources, Inc.	BEN	16.69	48.3%	6.2x	8.5x	0.71	2.9x
Invesco Ltd.	IVZ	9.08	43.8%	3.8x	5.1x	1.03	10.5x
Legg Mason, Inc.	LM	48.85	97.2%	14.0x	13.5x	0.80	12.1x
T. Rowe Price Group, Inc.	TROW	97.65	70.5%	11.2x	15.0x	1.86	8.7x
Virtus Investment Partners, Inc.	VRTS	76.11	53.7%	7.2x	6.0x	0.64	3.1x
Waddell & Reed Financial, Inc.	WDR	11.14	62.2%	6.5x	12.1x	1.16	4.4x
Group Median			**57.9%**	**7.4x**	**9.9x**	**0.96**	**8.7x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	APO	33.50	64.8%	8.6x	15.5x	3.42	7.0x
Ares Management Corp	ARES	30.93	74.8%	31.4x	19.0x	8.86	16.5x
Associated Capital Group Inc	AC	30.60	46.7%	nm	nm	24.47	7.1x
Blackstone Group Inc/The	BX	45.57	70.1%	15.3x	21.5x	8.43	12.4x
Carlyle Group LP/The	CG	21.65	62.4%	6.5x	13.7x	2.84	4.1x
Cohen & Steers Inc	CNS	45.45	58.5%	16.4x	20.8x	2.97	10.4x
Hamilton Lane Inc	HLNE	55.31	75.1%	29.6x	29.2x	7.98	24.5x
KKR & Co Inc	KKR	23.47	68.7%	6.6x	18.4x	26.61	nm
Och-Ziff Capital Management Group Inc	SCU	13.54	47.9%	18.6x	6.1x	4.48	25.6x
Group Median			**64.8%**	**15.8x**	**18.7x**	**7.98**	**11.4x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	59.14	51.9%	7.5x	8.0x	0.86	7.2x
Artisan Partners Asset Management Inc.	APAM	21.49	58.2%	8.9x	10.4x	1.52	6.3x
Focus Financial Partners Inc	FOCS	23.01	58.5%	9.3x	11.3x	na	13.1x
Victory Capital Holdings Inc	VCTR	16.36	66.1%	7.1x	8.2x	1.31	nm
Group Median			**58.3%**	**8.2x**	**9.3x**	**1.31**	**7.18**
OVERALL MEDIAN			**60.8%**	**8.9x**	**11.3x**	**1.09**	**7.9x**

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

Sectors Served

- Registered Investment Advisors
- Money Managers
- Wealth Management Firms
- Mutual Fund Companies
- Independent Trust Companies
- Investment Consultants
- Hedge Fund Managers
- Real Estate Investment Companies
- Private Equity & Venture Capital Firms
- Bank Trust Departments
- Broker-Dealers / Hybrid RIAs

Services

- Corporate Valuation
- Fairness Opinions
- M&A Representation & Consulting
- Buy-Sell Agreement Valuation & Consulting
- Financial Reporting Valuation
- Tax Compliance Valuation
- Litigation & Dispute Resolution Consulting/ Testimony
- ERISA Valuation

Mercer Capital's Investment Management Industry Team

Matthew R. Crow, ASA, CFA
901.322.9728
crowm@mercercapital.com

Brooks K. Hamner, CFA, ASA
901.322.9714
hamnerb@mercercapital.com

Zachary W. Milam
901.322.9705
milamz@mercercapital.com

Taryn E. Burgess, CFA
901.322.9757
burgesst@mercercapital.com

Mercer Capital

www.mercercapital.com