MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

VALUE FOCUS

Investment Management

Second Quarter 2020 | Segment Focus: Alternative 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. Despite the COVID-19 induced market volatility, RIA stocks are actually up over the last year. However, this increase should be evaluated in the proper context. Pre-COVID, the industry was already facing numerous headwinds including fee pressure, asset outflows, and the rising popularity of passive investment products. Many of these issues were masked until the bull market for the RIA industry came to a grinding halt in March before rallying again in April and May.

In our segment focus for this quarter, we look at alternative asset managers performance. Despite the global pandemic, the long-term outlook for most alternative asset managers appears healthy due to strong investor interest and emerging opportunities caused by market dislocation. In the near-term, alt managers are likely to feel the effects of declining asset values; however, when it comes to maintaining existing assets, alt managers are often better positioned during a market downturn than their traditional asset management counterparts.

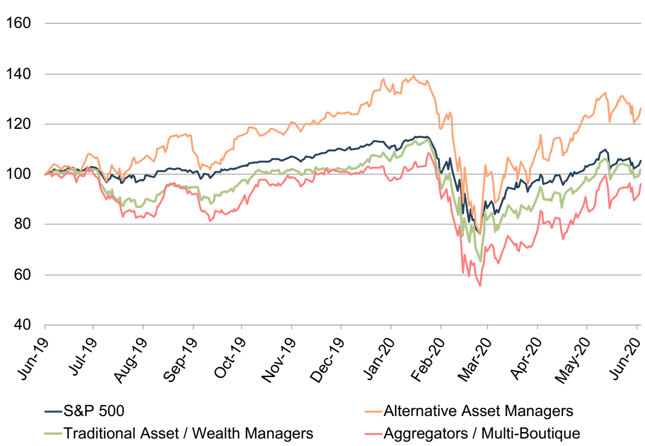
Also in this issue, we address industry M&A trends and factors driving deal activity. As anticipated, previously announced deals in the final stages of negotiations did close but new deal activity slowed some in the second quarter. In the second quarter of 2020, independent RIAs, rather than consolidators, drove much of the deal activity.

RIAs Stocks Rally After Worst Quarter in Eleven Years

Industry Now in a Bull Market Following March's Sell-Off

It probably doesn't feel like it, but most RIA stocks are up over the last year. Over this time, we've had two bull markets and one bear market in one of the most volatile twelve-month periods that we can remember. This volatility has been especially beneficial to alternative asset managers since hedge funds are usually well-positioned to take advantage of variability in security prices. The aggregators are the only segment of RIAs that are down over the last year since their models rely on debt financing, which exacerbated their losses during March's sell-off.

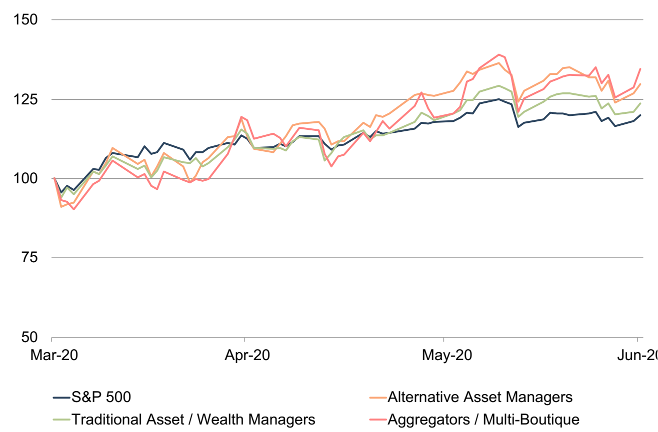
Investment Management Performance by Sector: Twelve Months Ended June 30, 2020



Source: S&P Global Market Intelligence

Last quarter showed the positive side to leverage as aggregators bested all other classes of RIAs during generally favorable market conditions in April and May. Other investment managers also fared well since collective AUM and ongoing revenue recovered with the market over the quarter. The primary driver behind the increase was the increase in the market itself, as most of these businesses are primarily invested in equities, and the S&P gained about 20% over the quarter.

Investment Management Performance by Sector: Q2 2020

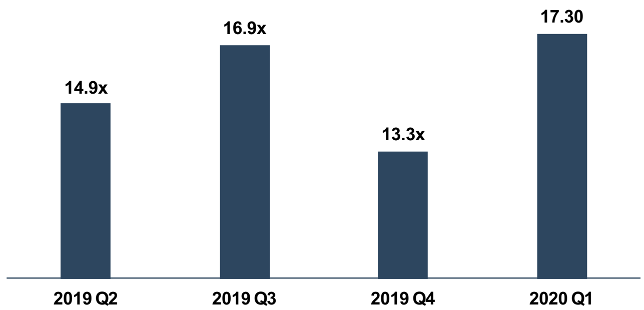


Source: S&P Global Market Intelligence

The recent uptick is promising, but it should be evaluated in the proper context. 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 in March before rallying again in April and May.

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 rise in Q2 after a sharp decline in the first quarter.

Median Price to LTM EPS for Traditional Asset / Wealth Managers



Source: S&P Global Market Intelligence

There are a number of explanations for this variation. Earnings multiples are primarily a function of risk and growth, and risk has waned since March's run-up and growth prospects have recovered. Specifically, future earnings are likely to increase with the recent rally, so the multiple has picked up as well since March's bottom. Conversely, the decline in Q1 reflected the market's anticipation of lower earnings with falling AUM and management fees. The multiple usually follows ongoing revenue, which is simply a function of current AUM and effective fee percentages, as discussed in a recent **post**.

Implications for Your RIA

During such volatile market conditions, the value of your RIA largely depends on the valuation date or date of measurement. In all likelihood, the value declined with the market in the first quarter before recovering most of that loss in the second. We've been doing a lot of valuation updates amidst this volatility, and there are several factors we observed in determining an appropriate amount of appreciation or impairment.

One, is the overall market for RIA stocks, which was down 20% in the first quarter (see chart above) before gaining just as much in the second to end up back in the same spot as year-end. The P/E multiple is another reference point, which has followed a similar path. 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 increased or diminished since the last appraisal, while being careful not to count good or bad news twice.

We also evaluate how our subject company is performing relative to the industry as a whole. Fixed income managers, for instance, held up reasonably well compared to their equity counterparts in the first quarter. We also look at how much of 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.

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 is that RIAs are all impacted by 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 improved with market conditions over the last couple of months. AUM has risen with the market over this time, and it's likely that industry-wide revenue and earnings have as well though year-end is still a high water mark for many RIAs.

Segment Focus: Alternative Asset Managers

Outlook During COVID-19

Demand for alt assets has benefited from increases in alt asset allocations among institutional investors, and this long-term trend appears poised to continue, pandemic or not. If anything, the current environment has highlighted the benefits of diversification that alt assets can provide. According to an **April 2020 survey** of institutional investors by Preqin, 63% of respondents indicated that COVID-19 would have no effect on their long-term alternative investment strategy, while 29% indicated that their long-term allocation to alternative investments would increase as a result of COVID-19.

In the near-term, however, alt managers are likely to feel the effects of declining asset values. While public equity markets recovered significantly in the second quarter, the recovery was led by a handful of large cap tech stocks while small caps lagged behind significantly. For PE firms, this means that most portfolio company valuations are likely down (and performance fees jeopardized), but it also represents an opportunity to deploy capital at attractive valuations.

Furthermore, while long-term investing strategies may be unchanged, capital commitments for the remainder of 2020 are likely to decline. According to the Preqin survey, only 9% of respondents indicated that COVID-19 has increased their planned commitments to alternatives in 2020, while 58% indicated that their planned commitments have decreased (33% indicated no change).

Of those commitments that are being made, they are likely to be concentrated in asset classes poised to benefit from the current environment. The brunt of the economic fallout from COVID-19 has been borne by a handful of industries, and given the severe short term impact (and possible longer term impact) that COVID has had on sectors like hospitality, energy, travel, retail, and restaurants, many investors are exercising caution and reducing exposure to these sectors at least until there is more clarity about the timeline of the pandemic and the potential long-run consequences. According to the Preqin survey, 34% of investors plan to avoid retail-focused real estate in 2020, while 28% plan to avoid conventional energy-focused natural resources and 26% plan to avoid retail-focused private equity.

On the other hand, certain alt asset categories like distressed debt and tech-focused venture capital, are poised to see increased investor interest. Distressed debt funds are raising record amounts of capital in anticipation of a rising number of investment opportunities. According to the Preqin survey, investors are planning to increase allocations to healthcare-focused private equity, distressed debt, logistics, software-focused venture capital, and defensive hedge funds.

When it comes to maintaining existing assets, alt managers are often better positioned during a market downturn than their traditional asset management counterparts. The investor base for alt managers tends to be largely institutional investors with long time horizons and perhaps less propensity to knee jerk reactions than retail investors. Also, since alt assets tend to be held in illiquid investment vehicles, investors are locked up for years at a time and can't withdraw funds as easily as if the assets were in a mutual fund or ETF.

While sticky assets can provide cushion for alt managers in a downturn, the longer-term performance of these managers depends on their ability to raise new funds and put that money to work. Raising institutional capital is often a long and involved process in the best of circumstances. For many managers, the economic interruption of a global shutdown has presented challenges to a fundraising process that often involves extensive in person due diligence (35% of respondents in the Preqin survey indicated that face-to-face meetings are essential for decision making). And if new funds are raised, there is the question of whether or not managers can put that money to work. M&A transaction activity has declined significantly over the last several months, leaving deal teams at many PE firms on the sidelines. It is likely that there will be a huge backlog of transaction activity that will materialize at some point in the coming months/years, but the timeline is uncertain.

Public alt managers were particularly affected during the sell-off in March, reflecting the decline in portfolio asset values and expectations for realizing performance fees. Measured from February 19, 2020—the day the S&P 500 peaked—our index of alt managers declined nearly 45% by late March. Since then, an outsized recovery has left the index down just 8.0% from the market peak. Of the nine alt asset managers in the index, six were down over the period while three saw price increases, which reflects the varied outlook for the sector depending on asset class focus, among other things.

The big winners in the sector were Apollo Global Management (APO) which was up 6.5% between the S&P 500 peak on February 19 and July 31 and KKR & Co. (KKR) which was up 4.8% over the same time period. APO saw credit AUM increase 43% over the second quarter, positioning the company to deploy capital as a robust pipeline of private credit opportunities emerges in the wake of COVID. Additionally, Apollo's recent focus on responsible investing, likely contributed to its superior performance as ESG funds outperformed traditional funds in the wake of COVID. KKR has also been successful at fundraising, adding $10 billion in capital commitments to its already substantial dry powder across its private equity and credit business during March and April. Those firms with large exposures to affected industries tended to see negative performance over the period. One of the worst performing companies in the index was Cohen & Steers (CNS), which was down 22% between Feb. 19 and July 31, reflecting its vulnerability due to its asset class focus (real estate) and predominately retail client base.

The observations about the divergence of performance among the public alt managers are likely to apply to privately held alt managers as well. In the near term, those managers with large exposures to highly affected industries, or those that have seen large asset outflows, are likely to see their valuations decline. Those managers with less exposure to highly affected industries, and those whose strategies and fundraising are poised to benefit from the current environment are likely to see valuations increase. Over the longer term, we expect to see alt asset allocations accelerate in the aftermath of COVID-19 as investors seek diversification before the next downturn, which should be a boon for most alt asset managers—particularly those who deliver outsized performance in the current environment.

RIA M&A Amid COVID-19

Independent RIAs Drive M&A During Downturn

The outlook for RIA M&A at the end of the first quarter was murky. While we did not expect deals already in motion to be canceled, we did expect **deal activity to temporarily slow**. We theorized that this slowdown could actually benefit the industry if RIA principals used the down time to think about succession planning. DeVoe & Company summarized similar expectations for RIA M&A in a Four Phase Outlook for M&A Post COVID-19 published in its **Q1 RIA Deal Book:**

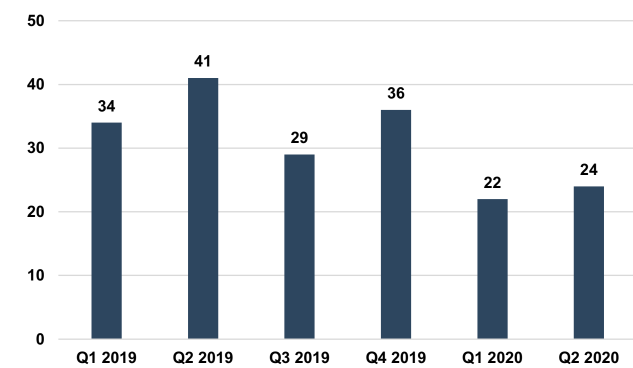
1. Live transactions get completed.
2. A lull in activity as owners respond to the COVID-19 pandemic rather than seek out new deals
3. A surge in activity caused by delayed deals coming to the market
4. Return to normalcy where the trends of increased M&A continue with an aging ownership base and a need for succession planning

So were our and other industry observers' expectations on track?

Review of M&A in Q2 2020

As anticipated, previously announced deals in the final stages of negotiations did close but new deal activity slowed some in the second quarter. According to **Fidelity's Wealth Management M&A Report**, M&A activity in January and February kept pace with 2019 levels but fell off in March, April, and May. There were 24 transactions involving RIAs with over $100 million but less than $20 billion in AUM announced in Q2 2020 (and many of these deals were announced in June 2020). Still this represents a decline in M&A activity compared with last year, as shown in the chart on the right.

Number of M&A Transactions by Quarter



Interestingly, in the second quarter of 2020, independent RIAs, rather than consolidators, drove much of the deal activity. In the second quarter, two independent RIAs—The Mather Group (TMG) and Creative Planning—accounted for approximately 21% of the total transactions announced, while consolidators accounted for only 17% of the deals.

The Mather Group (an independent wealth management firm with seven offices around the U.S.) announced its sixth acquisition in the last 18 months on June 16th, 2020, only one week after announcing a previous acquisition. The acquisition of Knoxville-based Resource Advisory Services, with $116 million in AUM, will bring TMG's AUM to over $3.9 billion. TMG's acquisition of Resource Advisory Services is indicative of a few M&A trends. First, in a relationship driven business such as wealth management, the fastest way to expand a firm's footprint is often through acquisitions. TMG has been working to expand its footprint into the Southeast and this acquisition is a sensible addition to their recent acquisition of Atlanta-based Barnett Financial. Additionally, this acquisition highlights a struggle many RIA owners face: a need for scale but a hesitation to partner with PE backed firms who have a reputation for pushing growth at all costs. Many RIA principals need a succession plan and private equity capital isn't always the right answer. Resource Advisory Services' founder David Lewis said, "I'm thrilled to **partner with a next-generation founder** who isn't private-equity backed, and feel very confident TMG's long-term vision will support my advisors into the future."

Creative Planning, based in Overland Park, Kansas, is one of the nation's largest independent RIAs, announcing three deals in the second quarter. Its most recent acquisition of Starfire Investment Advisers ($560 million AUM) was Creative Planning's eighth deal in 2020 and its twelfth deal since it started on its acquisition spree last year. As of February 2019, Creative Planning had grown its AUM organically to $38 billion. Since then it has acquired an additional $10 -12 billion in AUM. We expect to see more acquisitions from Creative Planning as it **strives to reach $100 billion in AUM and become more of a household name**. While Creative Planning is a driver in the trend of consolidation, it differentiates itself from traditional RIA consolidators by acquiring 100% of target companies and integrating them into the Creative Planning brand and investment philosophy. Additionally, while it is PE-backed, NY based General Atlantic holds a non-controlling, minority share.

Creative Planning's recent and planned M&A activity and investment from General Atlantic makes us ask: when does an RIA shift from being an **independent wealth manager** to an **acquirer** of independent wealth managers? Mercer Advisors (no relation) seemed to make this transition when it first started buying RIAs in 2016. Since then it has acquired around 30 advisory firms and has financed its acquisition activity by selling a sizeable stake in the company to PE firm Oak Hill Capital Partners while maintaining an investment from Genstar Capital.

The line between independent wealth manager and consolidator can be murky, but the trend this quarter was clear. Established consolidators, who primarily rely on debt financing or capital from PE firms, slowed acquisition activity in the second quarter. Dynasty Financial announced two deals in Q2, Focus Financial and Mercer Advisors (no relation) each announced one deal, and Wealth Enhancement Group and HighTower Advisors did not report any deal activity in the second quarter – while strategic acquisitions by independent RIAs continued.

RIA consolidators who use leverage to buy RIAs were much more vulnerable to the decline in the market at the end of March. Most RIA consolidators have never been through a market downturn and their balance sheets may have not been as well capitalized as needed to handle what many expected to be a few bad quarters and potentially years. With leverage on the balance sheet, interest coverage ratios became a concern for consolidators and the downturn in March likely served as a warning for aggregators to reevaluate their balance sheets. Most independent RIAs, on the other hand, have lived market downturns before and had capital built up to slug through a few bad quarters, and some even had the capital to acquire some firms when competition from other buyers temporarily eased.

Outlook for RIA M&A

While RIA M&A did slow some in Q2, we don't expect that this slowdown will continue as M&A activity has already picked back up in June. We have been contacted by several RIA principals who are using this time to reconsider their buy-sell agreements and their plans for their firms. These conversations often prompt strategic discussions which can pique some firms' interest in making acquisitions, can guide others down a path of internal succession planning as they prepare for retirement, and can serve as a wakeup call to others who are tired of dealing with the volatility inherent in many RIA practices. We also hope that the recent downturn and lack of activity from RIA consolidators leads buyers to proceed with more caution when partnering with leveraged consolidators. Amid a market downturn, when RIA principals should be focused on servicing client assets, the charge to save margin to meet interest coverage ratios will trickle down to the principal of those RIAs.

Investment Manager Multiples by Sector

	Ticker	6/30/2020 Stock Price	% of 52 Week High	Pricing as of June 30, 2020 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	113.67	77.8%	8.6x	nm	1.63	5.3x
GAMCO Investors, Inc.	GBL	13.31	64.0%	4.3x	nm	1.17	3.0x
Hennessy Advisors, Inc,	HNNA	7.89	64.3%	6.2x	nm	1.53	3.5x
Pzena Investment Management, Inc.	PZN	5.44	57.2%	13.3x	nm	1.59	12.0x
Silvercrest Asset Management Group	SAMG	12.71	92.4%	12.4x	9.9x	1.00	6.4x
Westwood Holdings Group, Inc.	WHG	15.75	47.4%	19.2x	nm	0.88	9.8x
Virtus Investment Partners, Inc.	VRTS	116.29	82.7%	9.2x	8.0x	0.95	3.7x
Group Median			**64.3%**	**9.2x**	**9.0x**	**1.17**	**5.3x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $100B)							
AllianceBerstein Investments, Inc.	AB	27.24	79.6%	10.4x	10.6x	1.47	6.3x
BlackRock, Inc.	BLK	544.09	95.7%	19.5x	19.2x	1.36	15.7x
Eaton Vance Corp.	EV	38.60	75.3%	12.2x	12.2x	1.22	9.7x
Federated Investors, Inc.	FHI	23.70	63.2%	8.1x	9.6x	0.43	6.6x
Franklin Resources, Inc.	BEN	20.70	60.7%	9.4x	8.9x	1.19	4.0x
Invesco Ltd.	IVZ	10.76	54.9%	4.9x	6.5x	1.30	10.9x
Legg Mason, Inc.	LM	49.75	99.8%	13.7x	13.8x	0.88	10.1x
T. Rowe Price Group, Inc.	TROW	123.50	89.9%	15.4x	15.1x	2.75	10.1x
Waddell & Reed Financial, Inc.	WDR	15.25	89.2%	9.4x	11.7x	1.90	5.8x
Group Median			**79.6%**	**10.4x**	**11.7x**	**1.30**	**9.7x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	SCU	49.92	90.1%	nm	25.3x	7.44	nm
Ares Management Corp	ARES	39.70	97.0%	15.2x	23.6x	10.10	nm
Associated Capital Group Inc	AC	36.69	56.2%	298.3x	nm	36.88	nm
Blackstone Group Inc/The	BX	56.66	87.9%	82.5x	27.9x	9.97	nm
Carlyle Group LP/The	CG	27.90	81.2%	84.3x	18.1x	5.24	36.3x
Cohen & Steers Inc	CNS	68.05	88.1%	23.9x	27.9x	5.75	20.7x
Hamilton Lane Inc	HLNE	67.37	88.7%	31.5x	35.6x	9.35	28.8x
KKR & Co Inc	KKR	30.88	90.9%	nm	20.8x	19.74	nm
Och-Ziff Capital Management Group Inc	SCU	12.93	45.7%	nm	8.1x	4.87	990.0x
Group Median			**88.1%**	**57.0x**	**24.5x**	**9.35**	**32.6x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	74.56	80.2%	10.4x	10.6x	1.15	8.1x
Artisan Partners Asset Management Inc.	APAM	32.50	90.1%	13.1x	11.7x	2.81	8.8x
Focus Financial Partners Inc	FOCS	33.05	94.5%	12.2x	12.2x	na	13.3x
Victory Capital Holdings Inc	VCTR	17.19	69.6%	8.1x	9.6x	1.33	na
Group Median			**85.1%**	**11.3x**	**11.2x**	**1.33**	**8.84**
OVERALL MEDIAN			**80.2%**	**12.8x**	**12.2x**	**1.56**	**9.8x**

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 asset 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

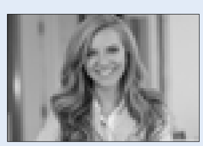
- Corporate Valuation
- Fairness Opinions
- M&A Representation & Consulting
- Buy-Sell Agreement Valuation & Consulting
- Financial Reporting Valuation
- Tax Compliance Valuation
- Litigation & Dispute Resolution Consulting/ Testimony
- ERISA Valuation

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, CFA
901.322.9705
milamz@mercercapital.com



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

Mercer Capital

www.mercercapital.com