VALUE FOCUS

Investment Management

Fourth Quarter 2022 | Segment Focus: Wealth Managers

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The wealth management industry experienced a tumultuous year in 2022, facing persistent inflation, rising interest rates, a tight labor market, and a broad decline across nearly all asset classes. In this newsletter, we take an in-depth look at the trends affecting the RIA industry and the state of the market, including the performance of publicly traded asset and wealth management firms, the state of the RIA M&A market, and the effect of macroeconomic factors on the wealth management industry.

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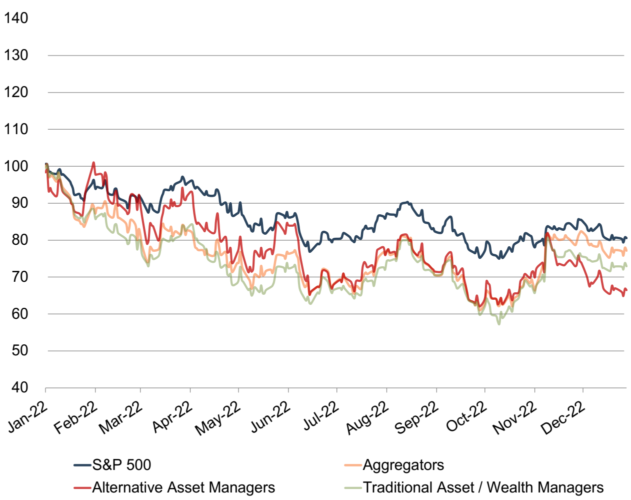
Segment Focus: Wealth Managers

Wealth Management in Turbulent Times

2022 proved to be a challenging year for the stock market as a whole and the RIA industry. With persistent inflation, rising interest rates, a tight labor market, and heightened geopolitical tensions, it's no surprise that this resulted in the decline of nearly all stock market sectors over the last year, which was especially true for the RIA industry. Investment manager performance is very much levered to the stock market due to its direct effect on AUM balances and the operating leverage inherent in the RIA model.

Investment Manager Performance by Sector
Year ended December 31, 2022



Source: S&P Global Market Intelligence

Public firms with substantial operations in the wealth management space were down 27% year-over-year, underperforming the broader market (the S&P 500 was down 19%) and aggregator models, like Focus Financial and CI Financial (down 23%).

This is in stark contrast to the uptrend seen for much of 2021. Prices for aggregator models accelerated into December of 2021, peaking as transaction activity in the space hit a fever pitch, fueled by higher multiples and the threat of changes in tax law that would make selling after year-end potentially disadvantageous.

The annual Schwab survey of wealth management firms (charts shown on the next page) confirmed the bullish sentiment going into 2022, with 69% of advisors expecting to grow at their current rate or faster.

Despite all the media attention given to consolidation activity in the wealth management sector, it's noteworthy that the advisors surveyed by Schwab saw ample opportunity to grow their firms organically. Nearly two-thirds of firms saw new client acquisition as a top driver of growth, while only 10% expected M&A to be a growth driver.

It is worth noting that the 2022 survey represents sentiment in October 2021 (when the study was conducted). In the fourteen months that have transpired since the survey, the market has had to digest higher inflation, a new uptrend in global interest rates, the Federal Reserve shrinking its balance sheet, and the war in Ukraine. The survey taken in late 2022 (when it's released) could prove that advisors now have a more pessimistic outlook on the market.

By the spring of 2022, many trends favoring wealth managers began to shift, threatening margins and valuations. Inflation in the U.S. hit a 40-year high in June of 2022 at 9.1%. In the second half of the year, inflation eased as the Federal Reserve aggressively raised interest rates and the economy began to cool, ending the year at 6.5%.

The Federal Reserve began increasing interest rates in March of 2022 and ended up hiking rates six more times during the year. By December 2022, the Federal Reserve's target rate was between 4.25% and 4.5%, the highest level in over 15 years. Higher interest rates have undermined valuations in both debt and equity markets, taking an unusually strong toll on everything from U.S. treasuries to tech stocks. This shift created a downward gravitational pull on assets under management and, therefore, revenue for wealth management firms. At the same time, inflationary forces have pushed up both labor and non-labor expenses for RIAs. The consequence could be challenging for margins in 2023 and could deflate some of the positive influences on profitability that have provided a tailwind to RIA valuations for several years.

Valuations may face additional pressure as rate increases by the Federal Reserve result in higher yields for other income-producing assets (making them a more attractive alternative to investing in RIAs), and the cost of capital increases on both the equity and debt sides of the equation for leveraged consolidators of wealth management firms.

With the prospect of a potential recession in 2023, the worst may still be ahead. While facing uncertainty heading into 2023, it will be important for wealth management firms to have a strategy in place to navigate these challenges and capitalize on opportunities that may arise.

Source: January 2022 Schwab Advisor Services Independent Advisor Outlook Study

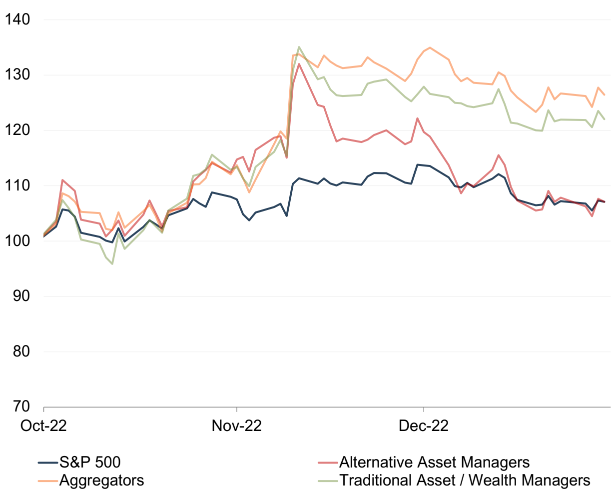
Source: January 2022 Schwab Advisor Services Independent Advisor Outlook Study

RIAs Outperform the S&P 500 in Q4 2022

Most RIA Stocks Have Lost Nearly Half Their Value Since Peaking Last November

The RIA industry saw a strong fourth quarter rally, driving most categories of publicly traded investment managers to outperform the S&P in the last quarter of the year. Alternative asset managers, however, declined from their early-November peak to perform in line with the S&P during this period.

Investment Manager Performance by Sector
Q4 2022



Source: S&P Global Market Intelligence

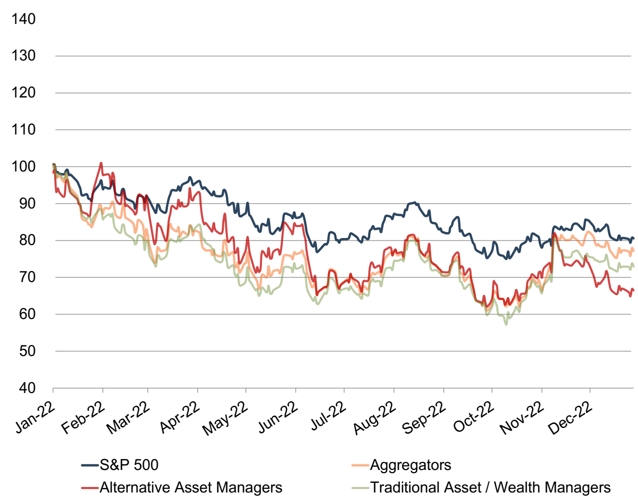
Performance by Sector

The uptick in the broader market during Q4 translated to an improved profitability outlook for asset managers due to their revenue model and operational leverage. With **inflationary pressures continuing to drive up operating costs**, it is yet to be seen how Q4 market gains translate to the bottom line.

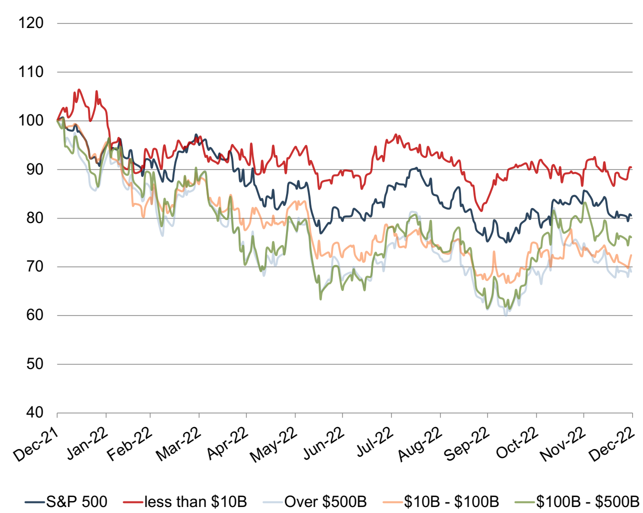
Performance by AUM

The largest asset managers saw the highest stock price growth in Q4, while smaller asset managers performed in line with the S&P. In our previous market update, we wrote that the smallest asset managers, those with AUM <$10 billion, were the only group to outperform the S&P for the year. This was still true at year end. Due to the Q4 gains experienced by larger asset managers (those with AUM between $100 and $500 billion), this group went from severely underperforming the S&P for the year at the end of Q3 to slightly underperforming the S&P at year end.

Investment Manager Performance by Sector
Year ended December 31, 2022



Investment Manager Performance by AUM Size
Year Ended December 31, 2022

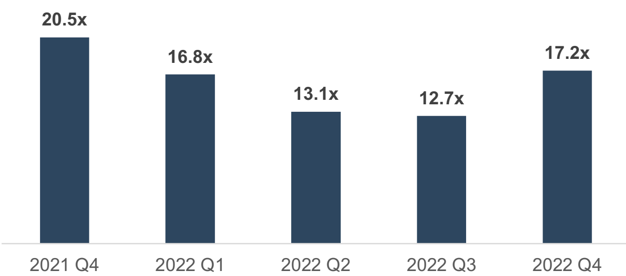


Source: S&P Global Market Intelligence

Multiple Arbitrage

Public RIA LTM earnings multiples are up 35% from the end of Q3 to the end of Q4. After steadily increasing over the second half of 2020 and throughout 2021, LTM earnings multiples for publicly traded asset and wealth managers have dropped 16% this year, reflecting investor anticipation of lower revenue and earnings from the recent market decline and rising cost structure. See the price to LTM earnings ratio for Traditional Asset / Wealth Managers below.

Price to LTM EPS for Traditional Asset / Wealth Managers



Source: S&P Market Intelligence

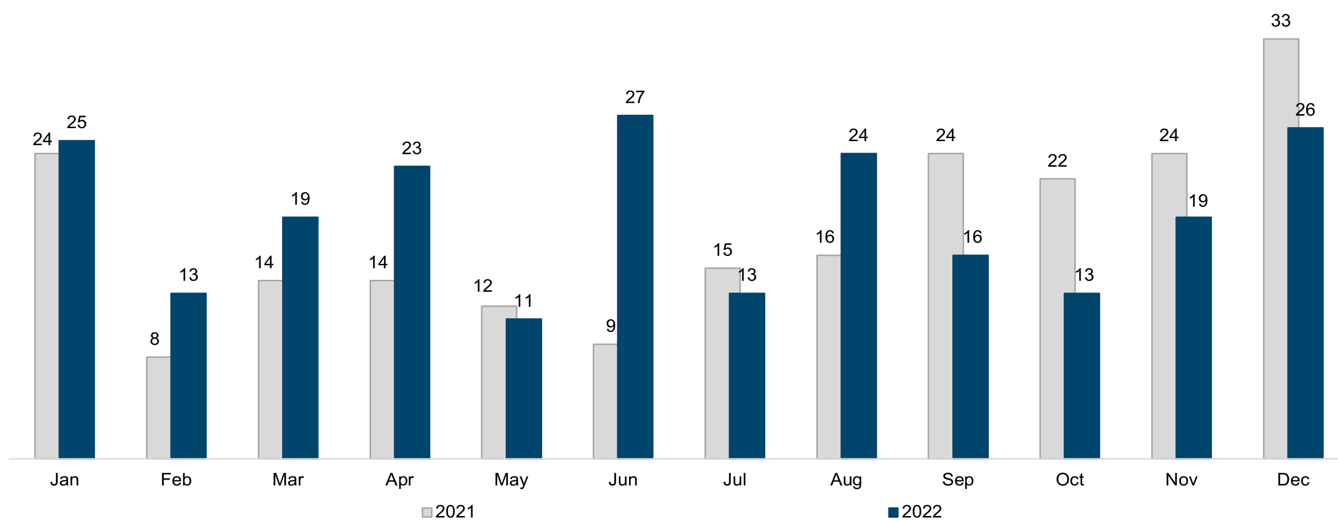
Implications for Your RIA

The value of public asset and wealth managers provides some perspective on investor sentiment towards the asset class, but strict comparisons with closely held RIAs should be made with caution. Many smaller publics are focused on active asset management, which has been particularly vulnerable to the headwinds such as fee pressure and asset outflows to passive products. Many sectors of closely held RIAs, particularly wealth managers, as well as larger public asset managers have been less impacted by these trends and have seen more resilient multiples as a result. In the case of wealth management firms, strong demand from aggregators has also helped to bolster pricing in recent years.

RIA M&A

Fourth Quarter 2022

Number of RIA M&A Transactions, 2021 vs 2022



RIA M&A activity set new records in 2022, even as macro headwinds for the industry emerged throughout the year. Fidelity's **December 2022 Wealth Management M&A Transaction Report** listed 229 deals through December 2022, up from 215 in 2021. However, deal volume was most significant in the first half of 2022 and began to cool in the second half of the year, particularly in the fourth quarter. Fidelity reported 58 deals in the fourth quarter of 2022, down 27% compared to the same period in 2021. Although transaction volume is still up over the prior year, there has been a decline in the size of these transactions. These transactions represented $283.8 billion in AUM, down 18% from 2021. Additionally, the median deal size declined 32% to $478 million in AUM.

The fourth quarter decline in M&A activity could be viewed as a delayed reaction to market conditions that emerged early in 2022. Inflation, rising interest rates, and a tight labor market have strained the supply and demand dynamics that have driven deal activity in recent years. Rising costs and interest rates coupled with a declining fee base have put pressure on highly leveraged consolidator models. A potential downturn in performance has left some sellers on the sidelines until fundamentals improve.

Despite these pressures, demand for RIAs remained strong throughout 2022, with professionalization of the buyer market continuing to be a theme driving M&A activity. Serial acquirers and aggregators increasingly drive deal volume with dedicated deal teams and access to capital. Mariner, CAPTRUST, Beacon Pointe, Mercer Advisors, Creative Planning, Wealth Enhancement Group, Focus Financial, and CI Financial all completed multiple deals throughout 2022.

While serial acquirers continue to be a major driver of M&A, market conditions in 2022 prompted several of these firms to temper their pace of acquisition activity and become more selective in their acquisition targets. CI Financial's CEO Kurt McAlpine remarked on the company's first-quarter earnings call that their pace of acquisitions has "absolutely slowed down." Despite this, multiples in the industry remain high relative to recent history, although the upward pressure on multiples has reportedly leveled off.

On the supply side, the current market environment is likely to have a mixed impact on bringing sellers to market. On one hand, some sellers may be reluctant to sell when the markets (and their firm's financial performance) are down significantly from their peak. On the other hand, a concern that multiples may decline if the current market environment persists may prompt some sellers to seek an exit while multiples remain relatively robust. This dynamic has prompted many sellers to hedge their exit by pursuing a partial sale now with an eye for a more complete exit once market conditions improve.

Although the decline of M&A activity in the fourth quarter could indicate that market conditions have led to the cooling of the M&A market, it is yet to be seen if this trend will continue into 2023. While market conditions play a role in exit timing, the motives for sellers often encompass more than purely financial considerations. Sellers are often looking to solve succession issues, improve quality of life, and access organic growth strategies. Such deal rationales are not sensitive to the market environment and will likely continue to fuel the M&A pipeline even in a downturn. Despite years of record-setting M&A activity, the number of RIAs continues to grow—which suggests the uptick in M&A activity is far from played out.

What Does This Mean for Your RIA?

For RIAs Planning To Grow Through Strategic Acquisitions

Pricing for RIAs has trended upwards in recent years, leaving you more exposed to underperformance. While the impact of current macro conditions on RIA deal volume and multiples remains to be fully seen, structural developments in the industry and the proliferation of capital availability and acquirer models will likely continue to support higher multiples than the industry has in the past. That said, a long-term investment horizon is the greatest hedge against valuation risks. Short-term volatility aside, RIAs continue to be the ultimate growth and yield strategy for strategic buyers looking to grow their practice or investors capable of long-term holding periods. RIAs will likely continue to benefit from higher profitability and growth compared to broker-dealer counterparts and other diversified financial institutions.

For RIAs Considering Internal Transactions

We're often engaged to address valuation issues in internal transaction scenarios. Naturally, valuation considerations are front of mind in internal transactions, as in most transactions. But how the deal is financed is often a crucial secondary consideration in internal transactions where buyers (usually next-gen management) lack the ability or willingness to purchase a substantial portion of the business outright. As the RIA industry has grown, so too has the number of external capital providers who will finance internal transactions. A seller-financed note has traditionally been one of the primary ways to transition ownership to the next generation of owners (and, in some instances, may still be the best option). Still, there is an increasing amount of bank financing and other external capital options that can provide the selling partners with more immediate liquidity and potentially offer the next-gen cheaper financing costs.

If You Are An RIA Considering Selling

Whatever the market conditions are when you go to sell, it is essential to have a clear vision of your firm, its value, and what kind of partner you want before you go to market. As the RIA industry has grown, a broad spectrum of buyer profiles has emerged to accommodate different seller motivations and allow for varying levels of autonomy post-transaction. A strategic buyer will likely be interested in acquiring a controlling position in your firm and integrating a significant portion of the business to create scale. At the other end of the spectrum, a sale to a patient capital provider can allow your firm to retain its independence and continue operating with minimal outside interference. Given the wide range of buyer models out there, picking the right buyer type to align with your goals and motivations is a critical decision that can significantly impact personal and career satisfaction after the transaction closes.

Investment Manager Multiples by Sector

				Pricing as of December 31, 2022			
	Ticker	12/31/2022 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	185.02	86.7%	9.9x	nm	2.13%	6.8x
GAMCO Investors, Inc.	GBL	15.24	59.2%	7.5x	nm	1.00%	2.6x
Hennessy Advisors, Inc,	HNNA	8.40	73.9%	12.8x	nm	1.54%	4.2x
Silvercrest Asset Management Group	SAMG	18.77	82.8%	23.9x	12.6x	0.97%	5.9x
Westwood Holdings Group, Inc.	WHG	11.13	55.7%	55.9x	nm	0.19%	5.3x
Group Median			**73.9%**	**12.8x**	**12.6x**	**1.00%**	**5.3x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $100B)							
BlackRock, Inc.	BLK	708.63	76.4%	23.8x	20.7x	1.37%	14.2x
Federated Investors, Inc.	FHI	36.31	91.2%	13.7x	13.3x	0.51%	7.3x
Franklin Resources, Inc.	BEN	26.38	72.4%	10.1x	10.3x	1.18%	5.8x
Invesco Ltd.	IVZ	17.99	71.0%	8.3x	10.9x	1.08%	7.7x
T. Rowe Price Group, Inc.	TROW	109.06	54.8%	12.6x	13.7x	1.89%	7.0x
Virtus Investment Partners, Inc.	VRTS	191.44	63.2%	8.7x	7.5x	1.01%	4.3x
Group Median			**71.7%**	**11.3x**	**12.1x**	**1.13%**	**7.2x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	APO	63.79	85.7%	nm	12.0x	7.87%	nm
Ares Management Corp	ARES	68.44	79.5%	61.4x	21.3x	7.85%	19.4x
Associated Capital Group Inc	AC	41.99	88.4%	nm	nm	29.21%	nm
Blackstone Group Inc/The	BX	74.19	53.4%	41.0x	14.4x	7.48%	nm
Carlyle Group LP/The	CG	29.84	53.3%	7.6x	7.0x	4.89%	11.5x
Cohen & Steers Inc	CNS	64.56	68.4%	17.5x	17.5x	3.81%	14.1x
Hamilton Lane Inc	HLNE	63.88	60.7%	71.8x	17.5x	2.80%	12.7x
KKR & Co Inc	KKR	46.42	61.7%	nm	12.0x	19.15%	nm
Sculptor Capital Management Inc	SCU	8.66	38.1%	7.6x	7.1x	3.59%	8.8x
Group Median			**61.7%**	**29.2x**	**13.2x**	**7.48%**	**12.7x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	158.43	92.4%	17.3x	8.0x	1.45%	7.5x
Artisan Partners Asset Management Inc.	APAM	29.70	61.2%	9.2x	9.7x	2.14%	5.8x
Focus Financial Partners Inc	FOCS	37.27	59.9%	47.6x	8.6x	nm	8.8x
Victory Capital Holdings Inc	VCTR	26.83	71.8%	8.9x	5.9x	1.86%	6.3x
Brightsphere Investment Group Inc	BSIG	20.58	77.7%	11.3x	12.9x	1.36%	5.7x
Group Median			**71.8%**	**11.3x**	**8.6x**	**1.65%**	**6.3x**
OVERALL MEDIAN			**71.0%**	**12.7x**	**12.0x**	**1.87%**	**7.0x**

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

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- Buy-Sell Agreement Valuation & Consulting
- Financial Reporting Valuation
- Tax Compliance Valuation
- Litigation & Dispute Resolution Consulting/ Testimony
- ERISA Valuation

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