VALUE FOCUS

Investment Management

Second Quarter 2023 | Segment Focus: Trust Companies

In This Issue

Publicly traded RIA aggregators and alternative asset managers experienced a second quarter rally, rising in line with the S&P 500. Traditional asset managers, on the other hand, underperformed the S&P for a second quarter in a row. From a size perspective, larger investment management firms (those with AUM greater than $100 billion) earned the bulk of the second quarter gains while smaller managers underperformed the broader market. The gains of the S&P and certain RIA segments are reflective of easing inflationary signs and its expected impact on future rate hikes. 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 fac-tors on the RIA industry.

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Segment Focus: Trust Companies

Trends with Independent Trust Companies

One of the most frequently ignored sectors in the wealth management industry may be its first cousin, the independent trust industry. While many still associate trust administration with banks, which still control more than 75% of the space, the growing prominence of independent trust companies is capturing the attention of many participants in the investment management community. In this section, we examine current trends impacting independent trust companies.

Fees

Since the credit crisis, there has been a broad-based decline in pricing power across the investment management industry. Competition from low-fee passively managed products and increasing fee consciousness among institutional clients has driven down effective realized fees for asset managers. Wealth management fees have been more resilient, but the threat of low-fee alternatives remains.

So how have trust companies fared in this environment? Despite pricing pressure in the broader industry, trust company pricing has held up reasonably well. Fee levels have been supported by increasing demand for trust administration services driven by generational wealth transfer trends and the increasing complexity of trust arrangements that require specialized knowledge with respect to legal, tax, regulatory, and investment matters. The story has been similar for many of our independent trust company clients. Realized fees have remained steady or increased over the last five years, while assets under administration have grown through market growth and net inflows.

Market Correlation

After a turbulent start to 2023, the stock market has since rallied, positively impacting the top line for trust companies, as it will for all investment managers that charge a percentage of assets under management. As of the date of this post, the S&P 500 is up around 19% year-to-date.

Normally, trusts are shielded from some of the market volatility because of relatively higher exposure to fixed income. However, the change in the term structure of interest rates over the past 18 months means bonds are well off their prices from a few years ago, resulting in a lower fee base for trust companies with fixed income exposure.

Unlike many asset and wealth management firms, trust companies often have revenue sources that aren't directly tied to assets under management or administration (e.g., tax planning or estate administration fees). Such fee structures can serve as a buffer during market downturns, providing trust companies with greater resilience in adverse market environments relative to their asset and wealth management peers.

Favorable Demographics

As America becomes older and wealthier, the number of potential clients for the trust industry is poised to grow markedly.

Trust companies primarily service high-net-worth and ultra-high-net-worth clients, and both demographics are growing. Credit Suisse's 2022 Global Wealth Report estimates that there are nearly 25 million people in the U.S. with a net worth over $1 million. This is more than double the number a decade ago and represents a 21% increase over the prior two years. At the same time, the median age in the U.S. has increased by 1.5 years in the past decade, and the oldest members of the baby boomer generation are now in their mid-70s.

The average age of high-net-worth individuals (those with a net worth over $1 million) is 57, and over two-thirds are over the age of 60. Consequently, there is a growing pool of clients in need of the kinds of services the trust industry provides, which points to a sustained period of organic growth. While this will also provide a tailwind for wealth management firms—who often start working for clients around the time they retire—it is a more certain opportunity for trust providers, especially to the extent that wealth transfer services are part of a client's overall financial plan.

Additionally, the impending wealth transfer as baby boomers age should spur growth in trust assets. According to Wealth Advisor's 2023 report, the heirs of baby boomers are expected to inherit roughly $3 billion a day or over $1 trillion annually over the next 30-35 years.

Regulatory Trends

As trust law has developed, a handful of states have emerged as particularly favorable for establishing trusts. While the trust law environment varies from state to state, leading states typically have favorable laws for asset protection, taxes, trust decanting, and general flexibility in establishing and managing trusts. Opinions vary, but the following states (listed alphabetically) are often identified with a favorable mix of these features.

- Alaska
- Delaware
- Florida
- Nevada
- South Dakota
- Tennessee
- Texas
- Wyoming

Over the last several decades, many states like Delaware, Nevada, and South Dakota have modernized their trust laws to allow for perpetual trusts, directed trustee models, and self-settled spendthrift trusts (or asset protection trusts). In particular, the directed trust model is a major change in how trust companies manage assets, and it has been gaining popularity among trust companies and their clients. Under the directed trust model, the trust's creator can delegate different functions to different parties. Most frequently, this involves directing investment management to an investment advisor other than the trust company (this could be a legacy advisor or any party the client chooses). Administrative functions and decisions on how the trust's assets are made available to beneficiaries are typically delegated to the trust company.

The directed trustee model leads to a mutually beneficial relationship between the trust company, the investment advisor, and the client. The trust company avoids competition with investment advisors, who are often their best referral sources. The investment advisor's relationship with their client is often written into the trust document. And most importantly, this model should result in better outcomes for the client because its team of advisors is ultimately doing what each does best—its trust company acts as a trustee or administrator, and its investment advisor is responsible for investment decisions.

Succession

In our experience, the ownership profile at independent trust companies is often similar to what we see at wealth management firms, where ownership succession is often a topic of conversation. Ownership issues can include concentration at the founder level or even extensive ownership held by outsiders who helped capitalize the firm's inception. As with most investment management businesses, independent trust companies tend to be owner-operator businesses, so conversations about equity ownership are frequently centered around finding effective ways to provide equity incentives to the individuals most impactful to the firm's future.

We've written about buy-sell agreements in **articles**, **blog posts**, and **whitepapers**. The dynamic of a multi-generational, arms-length ownership base can be an opportunity for ensuring the long-term continuity of the firm, but it also risks becoming a costly distraction. As the trust industry ages, we see transition planning as potentially being either a competitive advantage (if done well) or a competitive disadvantage (if ignored).

Outlook

The independent trust industry has showcased resilience and strong performance in recent years, even amidst market turbulence and evolving industry dynamics. Demographic shifts and increasing visibility as an attractive alternative to bank trust departments present an encouraging outlook for independent trust companies' growth in the foreseeable future. As these trends continue to shape the financial landscape, prudent planning, innovation, and adaptability will be crucial for trust companies aiming to thrive in the competitive investment management arena.

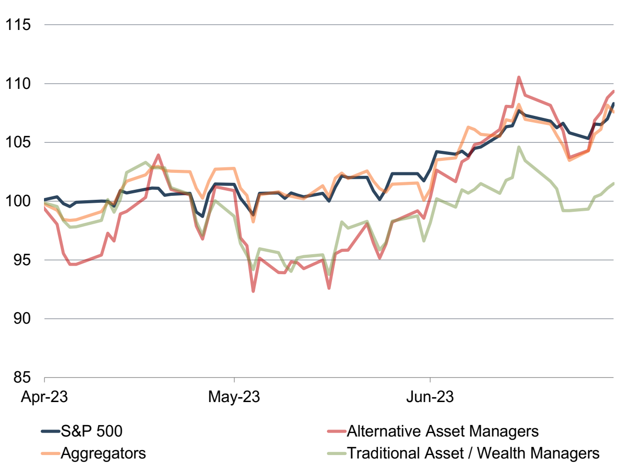
Q2 2023: RIAs Finish Strong Following June's Bull Market

Share prices for publicly traded asset and wealth management firms remained relatively stagnant for most of the first two months of Q2, tracking a broader market that struggled to find direction. In late May, however, the S&P 500 kicked off a summer rally that saw the index enter bull market territory in early June before continuing to notch an 8.3% gain for the quarter. This market uplift propelled AUM balances higher, and share prices for most categories of publicly traded asset and wealth management firms followed suit.

Performance by Sector

The market uptick and calming interest rate environment in Q2 translated to increased prices for publicly traded investment management firms. Prices for alternative asset managers and aggregators ended the quarter in sync with the S&P 500, while traditional asset managers saw a more modest increase during the quarter. In the last twelve months, most RIA sectors saw a modest decline in year-over-year earnings on lower fees from the 2022 downturn and a rising expense base. Aggregators outperformed other sectors during this period as **RIA M&A activity** remained elevated.

Investment Manager Performance by Sector
Q2 2023

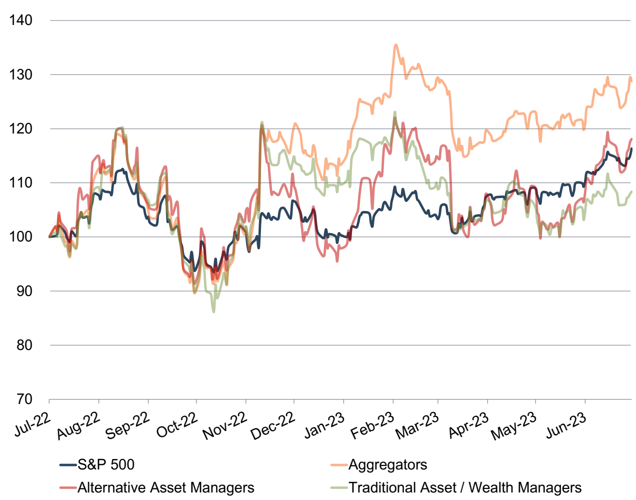


Source: S&P Global Market Intelligence

Performance by Size Category

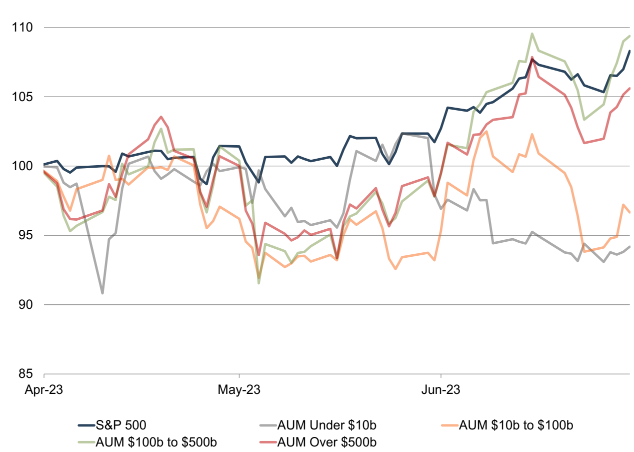
Smaller publicly traded asset managers (those under $100B AUM) underperformed the S&P 500 quarter-over-quarter and year-over-year. Larger asset managers performed in line with the broader market, with the $100B-$500B AUM group slightly outperforming and the largest size category during both periods.

Investment Manager Performance by Sector
Year ended June 30, 2023



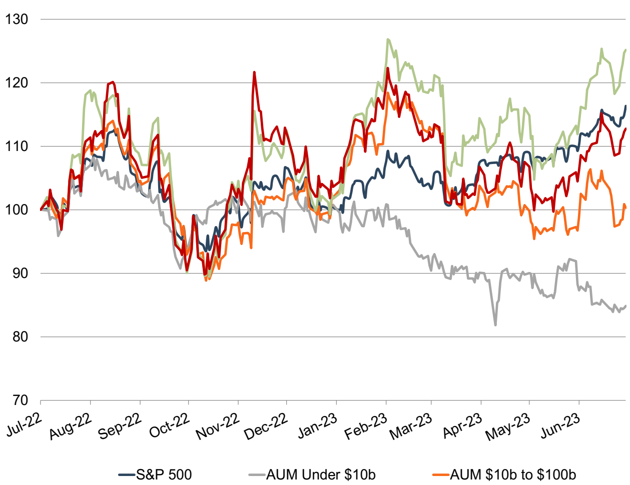
Source: S&P Global Market Intelligence

Investment Manager Performance by AUM Size
Q2 2023



Source: S&P Global Market Intelligence

Investment Manager Performance by AUM Size
Year Ended June 30, 2023

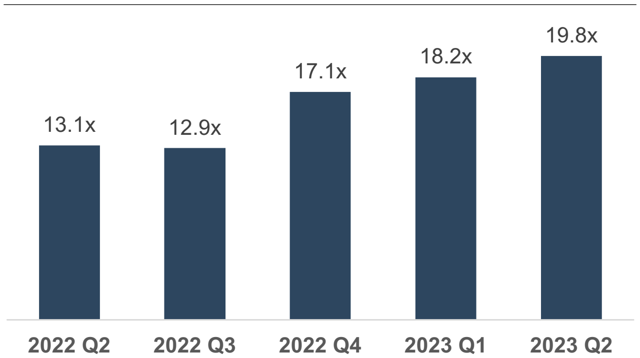


Source: S&P Market Intelligence

Pricing Trends

The median LTM earnings multiple for publicly traded asset and wealth management firms increased 8.8% during the second quarter of 2023, representing the third consecutive quarter of gains. After trending downwards for most of 2022, multiples began to increase in the fourth quarter and continued to rise the following quarter, as market conditions began to improve in October of last year. The multiple expansion in the second quarter also reflects the moderating interest rate environment and market rally during the period, translating into higher AUM balances and future earnings for RIAs.

Price to LTM EPS for Traditional Asset / Wealth Managers



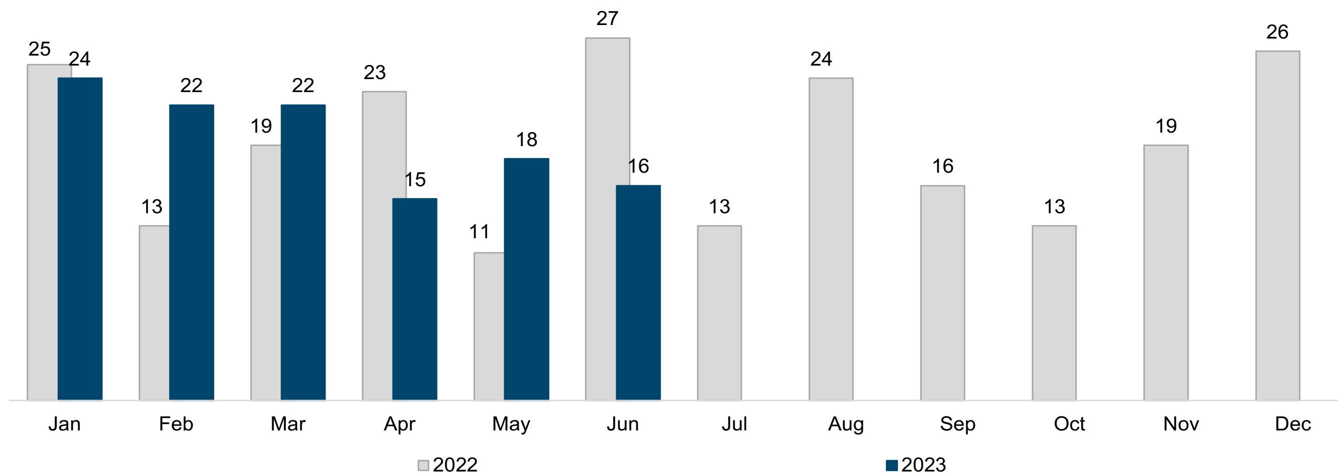
Implications for Your RIA

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 headwinds such as fee pressure and asset outflows to passive products. Many sectors of closely held RIAs, particularly wealth managers and 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. Focusing on the fundamentals of your RIA—**compensation structures,** cost controls, hiring practices, etc.—may offer protection from **arbitrary changes in market multiples.**

RIA M&A

Second Quarter 2023

Number of RIA M&A Transactions, 2022 vs 2023



Source: Fidelity

Although inflation has begun to subside and the stock market has rallied after a turbulent start to 2023, elevated interest rates and macroeconomic uncertainty have contributed to a slight decline in deal volume during the first half of 2023. Fidelity's June 2023 Wealth Management M&A Transaction Report listed 117 deals through June 2023, down 1% from the 118 deals executed during the same period in 2022. Despite the slight decline in deal volume, total transacted AUM was $176.4 billion—a 10% increase from the same period in 2022.

While deal volume during the first half of 2023 was roughly in line with 2022, there was a notable slowdown during the second quarter of 2023. Fidelity's transaction report listed 49 deals in the second quarter, a 20% year-over-year decline in deal count.

Relative to the broader M&A market, RIA deal activity has been remarkably resilient. The overall M&A transaction value for all industries in the U.S. decreased 44% in the first half of 2023 compared to 2022 (per S&P Global). Over the same period, total transacted AUM (a proxy for transaction value) for RIAs increased by 10%. The average AUM per transaction during the first half of 2023 was $1.5 billion, a 16% increase over the prior year. The increase in deal size has been an encouraging sign, given the rise in the cost of capital over the past year. Echelon's Q2 2023 RIA M&A Deal report states, "Firms with over $1 billion in AUM have been especially attractive to buyers as they tend to have experienced management and established processes and platforms". This growth in deals with AUM over $1 billion can also be attributed to the recovery of financial markets raising AUM levels overall in the industry.

Another contributor to the increase in deal size has been RIAs partnering with private equity firms. According to Echelon's Q2 2023 RIA M&A Deal report, private equity acquirers directly invested in wealth managers with assets totaling $351 billion in the second quarter of 2023, more than doubling the amount in 2022. This increase was due to some of the largest wealth management consolidators taking on new private equity partners. Notable transactions of this nature include **CI Financial,** which sold a 20% interest in its U.S wealth management business, CI Private Wealth, to a group of institutional investors, including Abu Dhabi Investment Authority, Bain Capital, Flexpoint Ford, Ares Management, and the state of Wisconsin.

The prevalence of serial acquirers and aggregators has continued in the RIA M&A market. In recent years, the professionalization of the buyer market and the entrance of outside capital have driven demand and increased competition for deals. Serial acquirers and aggregators have increasingly contributed to deal volume, supported by dedicated deal teams and access to capital. Such firms accounted for approximately 68% of transactions through the half of 2023. Mariner, CAPTRUST, Beacon Pointe, Wealth Enhancement Group, and Focus Financial all completed multiple deals in the half quarter of 2023.

On the supply side, the 2022 downturn will likely have a mixed impact on bringing sellers to market. On one hand, some sellers may be reluctant to transact when the markets (and their firm's financial performance) are still down from peak 2021 levels. On the other hand, a concern that multiples may decline if the recent uptick dissolves 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 stabilize.

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 during market downturns.

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 seen 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 than their 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, where valuation considerations are top of mind. 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, an increasing amount of bank financing and other external capital options can provide 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 June 30, 2023			
	Ticker	6/30/2023 Stock Price	% of 52 Week High	Price / Trailing EPS	Price / Forward EPS	Enterprise Value / AUM (%)	Enterprise Value / EBITDA
TRADITIONAL ASSET / WEALTH MANAGERS (AUM UNDER $250B)							
Diamond Hill Investment Group, Inc.	DHIL	171.30	87.0%	11.5x	nm	1.95%	8.4x
GAMCO Investors, Inc.	GAMI	19.16	87.2%	9.9x	nm	1.13%	nm
Hennessy Advisors, Inc.	HNNA	7.06	64.6%	13.0x	nm	1.22%	4.4x
Silvercrest Asset Management Group Inc.	SAMG	20.25	95.1%	33.7x	13.5x	0.93%	9.9x
Virtus Investment Partners, Inc.	VRTS	197.47	79.6%	10.4x	8.6x	0.90%	5.9x
Artisan Partners Asset Management Inc.	APAM	39.31	96.6%	16.9x	13.7x	2.42%	10.7x
Victory Capital Holdings, Inc.	VCTR	31.54	92.7%	11.8x	6.9x	1.90%	7.6x
BrightSphere Investment Group Inc.	BSIG	20.95	77.9%	11.0x	13.7x	1.10%	6.6x
WisdomTree, Inc.	WT	6.86	91.6%	15.0x	19.4x	1.33%	20.3x
Westwood Holdings Group, Inc.	WHG	12.40	79.7%	34.7x	nm	0.46%	11.1x
Group Median			**87.1%**	**12.4x**	**13.6x**	**1.17%**	**8.4x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $250B)							
BlackRock, Inc.	BLK	691.14	88.0%	26.6x	19.7x	1.17%	16.1x
Federated Hermes, Inc.	FHI	35.85	78.7%	14.3x	10.8x	0.42%	7.7x
Franklin Resources, Inc.	BEN	26.71	77.7%	12.8x	11.4x	1.04%	6.7x
Janus Henderson Group plc	JHG	27.25	87.1%	11.5x	12.4x	1.13%	7.0x
Affiliated Managers Group, Inc.	AMG	149.89	83.0%	16.5x	7.8x	1.22%	7.3x
Invesco Ltd.	IVZ	16.81	81.8%	9.1x	10.0x	0.93%	9.4x
T. Rowe Price Group, Inc.	TROW	112.02	83.2%	17.8x	16.7x	1.80%	8.8x
Group Median			**83.0%**	**14.3x**	**11.4x**	**1.13%**	**7.7x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, Inc.	APO	76.81	99.0%	nm	11.7x	8.68%	nm
Ares Management Corporation	ARES	96.35	99.0%	67.9x	25.6x	9.11%	30.5x
Associated Capital Group, Inc.	AC	35.40	79.6%	nm	nm	21.14%	nm
Blackstone Inc.	BX	92.97	83.8%	156.3x	21.2x	8.74%	nm
The Carlyle Group Inc.	CG	31.95	81.1%	20.2x	11.2x	5.04%	12.2x
Cohen & Steers, Inc.	CNS	57.99	73.5%	17.8x	19.4x	3.43%	12.7x
Hamilton Lane Incorporated	HLNE	79.98	98.5%	72.9x	22.4x	3.01%	13.3x
KKR & Co. Inc.	KKR	56.00	92.5%	154.9x	15.9x	21.42%	nm
Group Median			**88.2%**	**70.4x**	**19.4x**	**8.71%**	**13.0x**
AGGREGATORS							
Focus Financial Partners Inc.	FOCS	51.87	99.7%	135.1x	13.5x	nm	12.4x
Group Median			**99.7%**	**135.1x**	**13.5x**	**nm**	**12.4x**
OVERALL MEDIAN			**85.4%**	**17.8x**	**13.5x**	**1.80%**	**9.4x**

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

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- 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

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- Fairness Opinions
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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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