VALUE FOCUS

# Asset Management Industry

SEGMENT FOCUS

## Asset Managers

## 2018



Q1: Asset Managers

Q2: Wealth Managers

Q3: Alternative Asset Managers

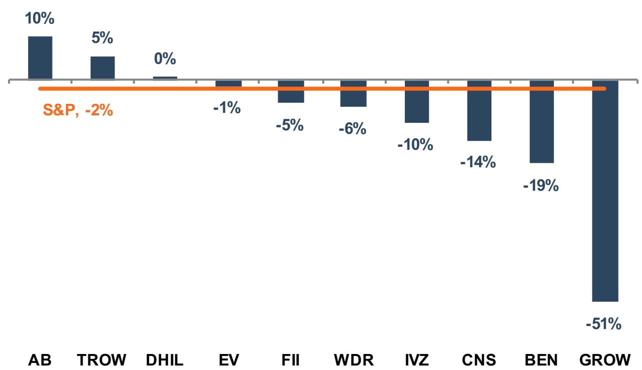
Q4: Trust Banks

# Segment Focus
## Asset Managers

Publicly traded asset managers had a rough first quarter, as volatility returned to the market and major indices posted negative quarterly returns for the first time in over two years. While the overall drop in the market was relatively modest, stock price declines of publicly traded asset managers were generally more significant (Chart 1). It is not surprising that most asset managers have underperformed during periods of declining markets, since the reverse was true during 2017 when most RIAs outperformed the major indices by a fairly significant margin. To the extent top-line volatility is tied to AUM movements and costs are fixed, market swings will have a magnified impact on earnings (and stock prices) for these businesses.

**Chart 1: Asset Management Performance vs S&P**

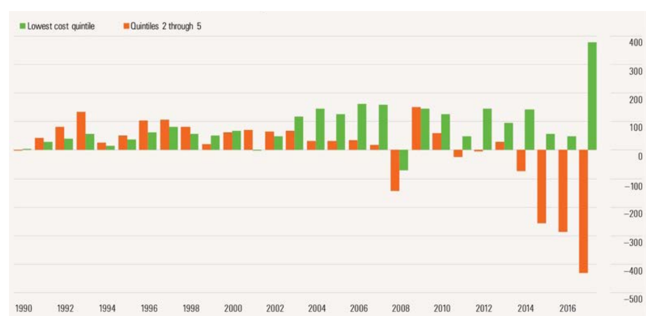
First Quarter 2018




*Source: S&P Global Market Intelligence*

**Chart 2: Annual Net Flows for Active Funds by Fee Quintile**

$ Billions




*Source: Morningstar Direct*

The return of market volatility and the reintroduction to the idea that markets can, in fact, go down, have brought back into focus the industry headwinds which, at least for the last several years, have been allayed by a favorable market backdrop. Notably, outflows from higher cost funds have continued to increase, as shown in Chart 2. During 2017, the chart shows accelerating outflows from the most expensive active funds and record inflows into the cheapest ones. These dynamics are problematic for many mutual fund companies and other asset managers that rely on active equity products which are necessarily more expensive to implement than their passive counterparts.

Despite this trend, there was one positive development related to asset flows for active managers during 2017, which is that aggregate outflows for active funds in 2017 were stemmed considerably (in fact were nearly zero). Relative to the significant net outflows active funds as a whole have seen for the last several years, this seems like a win for the sector (if you count less of a bad thing as a good thing). Still, if stemming the outflows comes at the cost of lowering fees, the result will be lower revenue yields and profitability.

It appears that stemming outflows without significant fee cuts will be an uphill battle. Active fund outflows are not only attributable to the rise in popularity of low-cost ETF strategies, but also sector-wide underperformance against their applicable benchmarks. Both individual and institutional investors are now more inclined to shun active managers for cheaper, more readily available products, particularly when performance suffers.

Active manager performance was better in 2017, although still less than half managed to beat their passive peers on a net-of-fee basis. According to data from *Morningstar*, 43% of active managers outperformed passive peers in 2017 versus 26% in 2016.

It appears that as long as active managers are missing the mark on their value proposition (alpha net of fees), ETFs and other passive strategies will continue to gain substantial inflows from active managers, resulting in higher and higher allocations to index products. With improved performance relative to passive funds in 2017 and a volatile market so far in 2018, the opportunity is there to reverse this trend. However, it will take sustained alpha generation before things start to go the other way, and in the interim, funds with a low active share and high fees are not likely to fare well. We've all read that consistently beating the market is nearly impossible, even for the savviest of stock pickers, but none of that research was compiled when passive strategies dominated the investment landscape.

We don't foresee a huge shift back to active management any time soon, but we realize that we were probably overdue for some mean reversion. It is conceivable that the current market environment could be more conducive to stock picking, but we'll need more time to judge whether this is truly the case. Regardless, it is hard to imagine that passive investing will completely replace active management. Such a scenario could lead to significant mispricing in the securities markets, which would be fertile ground for enterprising investors and mutual funds. This is why we say that active management may be down but is not out.

# Market Overview

## Asset Manager Performance by Size and Type

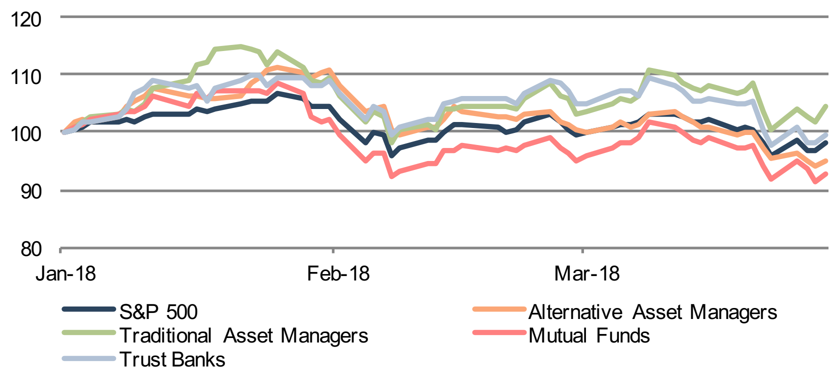
A rocky first quarter was particularly volatile for publicly traded RIAs. After reaching record highs in late January, most categories of publicly traded RIAs ended the quarter with negative returns.

The weak performance of publicly traded RIAs during the first quarter comes on the heels of significant outperformance during 2017, during which market gains apparently trumped fee compression, fund outflows, regulatory overhang, rising costs, and a host of other industry headwinds that have dominated the headlines in recent years. The simple explanation for the industry's performance in recent years is that the combination of market appreciation and operating leverage have precipitated significant improvements in profitability since the Financial Crisis, eliciting a favorable response from investors despite everything we've been reading about the industry. But the return of market volatility and market declines have brought back into focus these industry headwinds, and investors have reacted accordingly.

Upward or downward trends in the broader market tend to have a magnified effect on the stock prices of asset managers, because to the extent top line volatility is tied to AUM movements and some costs are fixed. While 2017 was a great year for the S&P and an even better year for most categories of RIAs, 2018 has been the complete opposite thus far. This reversal is no surprise, as historically corrections and bear markets have lead to more precipitous declines in profitability due to the presence of fixed expenses in most RIA's capital structure, a fact illustrated by the significant underperformance of asset managers during 2008 and early 2009.

**Chart 3: Asset Manager Performance by Sector**

First Quarter 2018

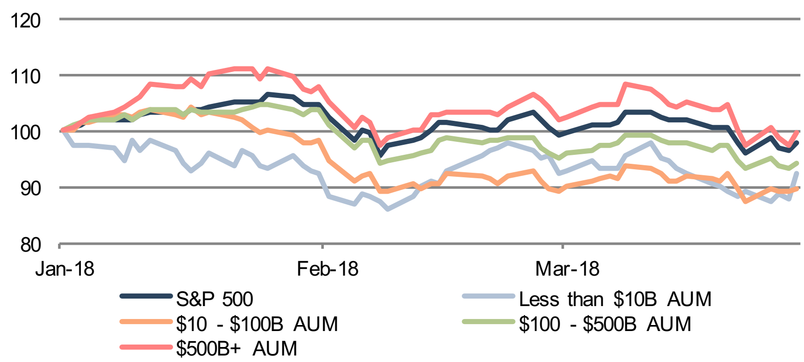



*Source: S&P Global Market Intelligence*

Taking a closer look at recent pricing reveals that traditional asset managers and trust banks have outperformed the S&P and other classes of asset managers throughout the first quarter (Chart 3). Traditional asset managers ended the quarter up 4.5% and were the only category of RIAs to post positive returns. Trust banks were down just 0.3% during the quarter, buoyed by a steadily rising yield curve, which portends higher NIM spreads and reinvestment income. Alternative asset managers were down 5.0% during the quarter as these businesses continue to find delivery on their value proposition (alpha net of fees) elusive. Mutual funds, which have been battered by active outflows and fee compression, were down 7.1% on the quarter.

**Chart 4: Asset Manager Performance by Size**

First Quarter 2018




*Source: S&P Global Market Intelligence*

The RIA size graph in Chart 4 shows that larger RIAs generally performed better than smaller RIAs during the first quarter. Asset managers with more than $500 billion in AUM were the only category to outperform the S&P, and RIAs with less than $100 billion in AUM performed the worst. This is to be expected during periods in which the market declines, as smaller RIAs generally have narrower margins and profitability can shift wildly with small changes in AUM.

The outlook for these businesses is similarly market driven – though it does vary by sector. Trust banks are more susceptible to changes in interest rates and yield curve positioning. Alternative asset managers tend to be more idiosyncratic but still influenced by investor sentiment regarding their hard-to-value assets. Mutual funds and traditional asset managers are more vulnerable to trends in active and passive investing. The outlook for the industry during the rest of 2018 ultimately depends on how the industry headwinds continue to evolve and (as always) what the market does over the next few months.

# M&A Review

Asset manager M&A was robust through the first quarter of 2018 against a backdrop of volatile market conditions. Total deal count during the first quarter was up 32% compared to the first quarter of 2017, though total disclosed deal value was down 25%. In terms of deal count, M&A is on pace to reach the highest levels since 2014, although we note that the quarterly data can be lumpy. Several trends which have driven the uptick in sector M&A have continued into 2018, including revenue and cost pressures and an increasing interest from bank acquirers and roll-up firms.

The underpinnings of the M&A trend we've seen in the sector include increasing compliance and technology costs, broadly declining fees, and slowing organic growth for many active managers. While these pressures have been compressing margins for years, sector M&A has historically been muted, due in part to challenges specific to asset manager combinations, including the risks of cultural incompatibility and size impeding alpha generation. Nevertheless, the industry structure has a high degree of operating leverage, which suggests that scale could alleviate margin pressure for certain firms.

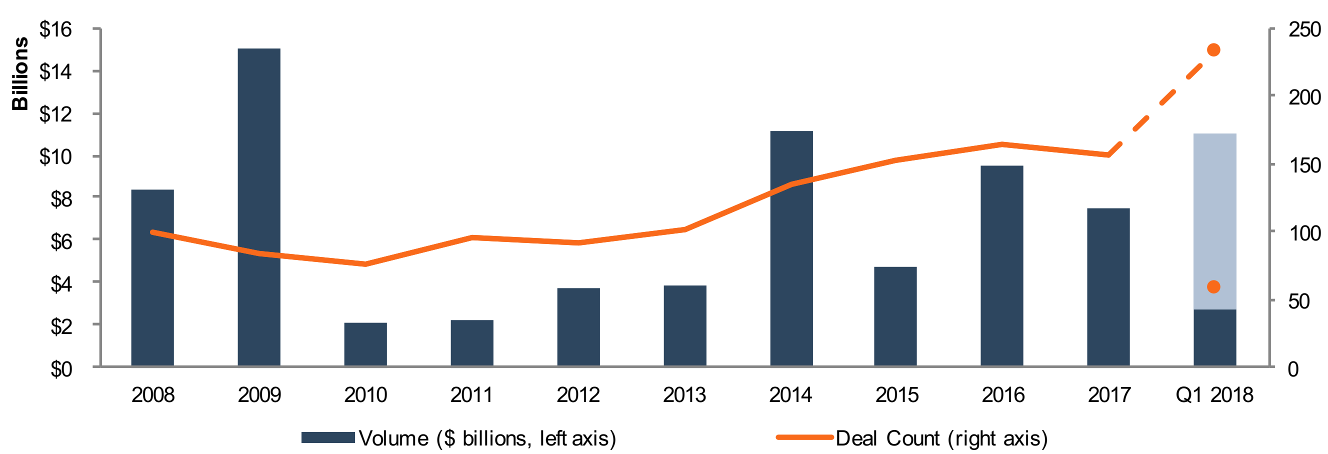
*"Since I've been in the industry, there's been declarations of massive consolidation. I do think though, this time there are a set of factors in place that weren't in place before, where scale does matter, largely driven by the cost coming out of the regulatory environments and the low rate environments in cyber and alike. And, you have to be, as a firm, you have to be able to invest in the future. And I think a number of smaller-sized firms are finding that hard."*

– Martin Flanagan
President and CEO, Invesco Ltd. 1Q17 Earnings Call

*"You need to have, of course, the right product set. But you need especially to have underlying firms, which are positioned as best they can in terms of alignment and focus to sustain alpha generation. And in that respect, scale is the enemy, not the friend."*

– Sean Healey
Affiliated Managers Group Inc. 1Q17 Earnings Call

**Asset Manager M&A** (2008 – Q1 2018)




*Source: Bloomberg*
*Transactions involving US-based targets and buyers*

Consolidation pressures in the industry are largely the result of secular trends. On the revenue side, realized fees continue to decrease as funds flow from active to passive. On the cost side, an evolving regulatory environment threatens increasing technology and compliance costs. Over the past several years, these consolidation rationales have led to a significant uptick in the number of transactions as firms seek to gain scale in order to realize cost efficiencies, increase product offerings, and gain distribution leverage.

Acquisition activity in the sector has been led primarily by RIA consolidators, with Focus Financial Partners (which itself was acquired by Stone Point Capital and KKR in a $2 billion deal last year), Mercer Advisors (no relation), and United Capital Financial Advisers each acquiring multiple RIAs over the last year. While these serial acquirers account for the majority of M&A activity in the sector, banks have also been increasingly active acquirers of RIAs in their hunt for returns not tied to interest rate movements. Despite a rising yield curve and the negative impact of goodwill on tangible book value, we suspect that RIAs will remain attractive targets for bank acquirers due to the high margins (relative to many other financial services businesses), low capital requirements, and cross-selling opportunities.

Recent increases in M&A activity come against a backdrop of a bull market that continued unabated through 2017 but faltered during the first quarter of 2018. Steady market gains continued throughout 2017 and more than offset the consistent and significant negative AUM outflows that many active managers have seen over the past several years. In 2016, for example, active mutual funds' assets grew to $11 trillion from $10.7 trillion, despite $400 billion in net outflows according to data from *Bloomberg*. And while the first quarter of 2018 saw negative returns for most major indices, the gains seen during 2017 have yet to be eroded. At the end of the first quarter the S&P, was down nearly 10% from its peak in late January 2018, but the index is still only 2% below year-end 2017. As a result of increasing AUM and concomitant revenue growth (perhaps notwithstanding this last quarter), profitability has been trending upwards despite industry headwinds that seem to rationalize consolidation.

With no end in sight for the consolidation pressures facing the industry, asset manager M&A appears positioned for continued strength or potential acceleration regardless of which way the markets move during the rest of 2018. Given the uncertainty of asset flows in the sector, we expect firms to continue to seek bolt-on acquisitions that offer scale and known cost savings from back office efficiencies. Expanding distribution and product offerings will also continue to be a key acquisition rationale as firms have struggled with organic growth.

With over 11,000 RIAs currently operating in the U.S., the industry is still very fragmented and ripe for consolidation. An aging ownership base is another impetus, and recent market gains might induce prospective sellers to finally pull the trigger. More broadly, the recent tax reform bill is expected to free up foreign-held cash and increase earnings, which could further facilitate M&A's upward trend during the rest of 2018.

### Asset Manager Multiples by Sector

| | Ticker | 3/31/2018 Stock Price | % of 52 Week High | Pricing as of March 31, 2018 Price / Trailing EPS | Price / Forward EPS | Enterprise Value / AUM (%) | Enterprise Value / EBITDA |
|---|---|---|---|---|---|---|---|
| **TRADITIONAL ASSET MANAGERS** | | | | | | | |
| Affiliated Managers Group, Inc. | AMG | $189.58 | 87.5% | 10.9x | 10.6x | 1.68 | 14.6x |
| BlackRock, Inc. | BLK | $541.72 | 91.6% | 24.6x | 18.9x | 1.45 | 15.0x |
| Legg Mason, Inc. | LM | $40.65 | 86.8% | 14.7x | 11.8x | 0.70 | 12.7x |
| Pzena Investment Management, Inc. | PZN | $11.13 | 88.1% | -9.1x | 12.9x | 1.99 | 9.6x |
| Westwood Holdings Group, Inc. | WHG | $56.49 | 80.9% | 18.2x | nm | 1.94 | 12.2x |
| **Group Median** | | | **87.5%** | **14.7x** | **12.4x** | **1.68** | **12.7x** |
| **MUTUAL FUNDS** | | | | | | | |
| AllianceBerstein Investments, Inc. | AB | $26.85 | 98.0% | 10.9x | 10.6x | 0.49 | nm |
| Cohen & Steers, Inc. | CNS | $40.66 | 85.7% | 18.6x | 15.7x | 2.80 | 10.0x |
| INVESCO Ltd. | IVZ | $32.01 | 84.0% | 13.8x | 10.6x | 2.02 | 11.7x |
| Franklin Resources, Inc. | BEN | $34.68 | 80.4% | 10.9x | 12.4x | 1.51 | 4.7x |
| Diamond Hill Investment Group, Inc. | DHIL | $206.56 | 95.2% | 17.5x | nm | 3.00 | 7.8x |
| Eaton Vance Corp. | EV | $55.67 | 91.8% | 20.9x | 16.5x | nm | 12.5x |
| Hennessy Advisors, Inc, | HNNA | $19.30 | 96.5% | 9.8x | nm | 2.36 | 6.5x |
| Manning & Napier, Inc. | MN | $3.50 | 61.9% | 2.6x | 13.0x | nm | nm |
| T. Rowe Price Group, Inc. | TROW | $107.97 | 90.5% | 18.7x | 15.0x | 2.65 | 10.9x |
| U.S. Global Investors, Inc. | GROW | $2.53 | 33.9% | 37.2x | nm | 4.90 | nm |
| Waddell & Reed Financial, Inc. | WDR | $20.21 | 84.8% | 12.7x | 9.1x | 2.04 | 6.9x |
| Federated Investors, Inc. | FII | $33.40 | 91.5% | 15.8x | 12.2x | 0.85 | 8.8x |
| Virtus Investment Partners, Inc. | VRTS | $123.80 | 91.1% | 17.8x | 10.2x | 1.46 | 9.3x |
| **Group Median** | | | **90.5%** | **15.8x** | **12.3x** | **2.04** | **9.1x** |
| **ALTERNATIVE ASSET MANAGERS** | | | | | | | |
| Apollo Global Management, LLC | APO | $29.62 | 80.9% | 17.0x | 9.4x | 3.39 | 5.3x |
| Blackstone Group L.P. | BX | $31.95 | 87.3% | 189.4x | 10.3x | 8.52 | 8.6x |
| Carlyle Group, L.P, | CG | $21.35 | 83.6% | 7.1x | 8.3x | 4.15 | 4.6x |
| Kohlberg Kravis Roberts & Co. | KKR | $20.30 | 83.5% | 11.1x | 8.2x | 19.39 | nm |
| Oaktree Capital Group, LLC | OAK | $39.60 | 85.0% | 9.6x | 11.7x | 10.12 | 10.7x |
| Och-Ziff Capital Mgmt Group LLC | OZM | $2.67 | 70.0% | 2.6x | 5.7x | 4.56 | 5.4x |
| **Group Median** | | | **83.5%** | **10.4x** | **8.9x** | **6.54** | **5.4x** |
| **TRUST BANKS** | | | | | | | |
| Northern Trust Corporation | NTRS | $103.13 | 93.1% | 21.2x | 16.7x | nm | nm |
| Bank of New York Mellon Corporation | BK | $51.53 | 87.7% | 15.2x | 12.8x | nm | nm |
| State Street Corporation | STT | $99.73 | 87.7% | 15.5x | 13.0x | nm | nm |
| **Group Median** | | | **87.7%** | **15.5x** | **13.0x** | **nm** | **nm** |
| **OVERALL MEDIAN** | | | **87.3%** | **15.2x** | **11.8x** | **2.20** | **9.4x** |


Data Source: S&P Global Market Intelligence

MERCER CAPITAL

5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137

## In This Issue



## About Value Focus Asset Management Industry

Mercer Capital's Value Focus is a quarterly publication providing perspective on valuation issues pertinent to asset managers, trust companies, and investment consultants. Each issue highlights a market segment: 1st quarter: Asset Managers, 2nd quarter: Wealth Managers, 3rd quarter: Alternative Asset Managers, and 4th quarter: Trust Banks. View past issues at www.mercercapital.com.

## About Mercer Capital

As one of the largest valuation firms in the United States, Mercer Capital provides asset managers, trust companies, and investment consultants with corporate valuation, financial reporting valuation, transaction advisory, portfolio valuation, and related services.

**Matt Crow, ASA, CFA**
President
901.322.9728
crowm@mercercapital.com

**Brooks Hamner, CFA, ASA**
Vice President
901.322.9714
hamnerb@mercercapital.com

**Zachary W. Milam**
Financial Analyst
901.322.9705
milamz@mercercapital.com

**www.mercercapital.com**

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