2020 Alternative Asset Manager Update

Are Sustainable Investments the Future of Investment Management?

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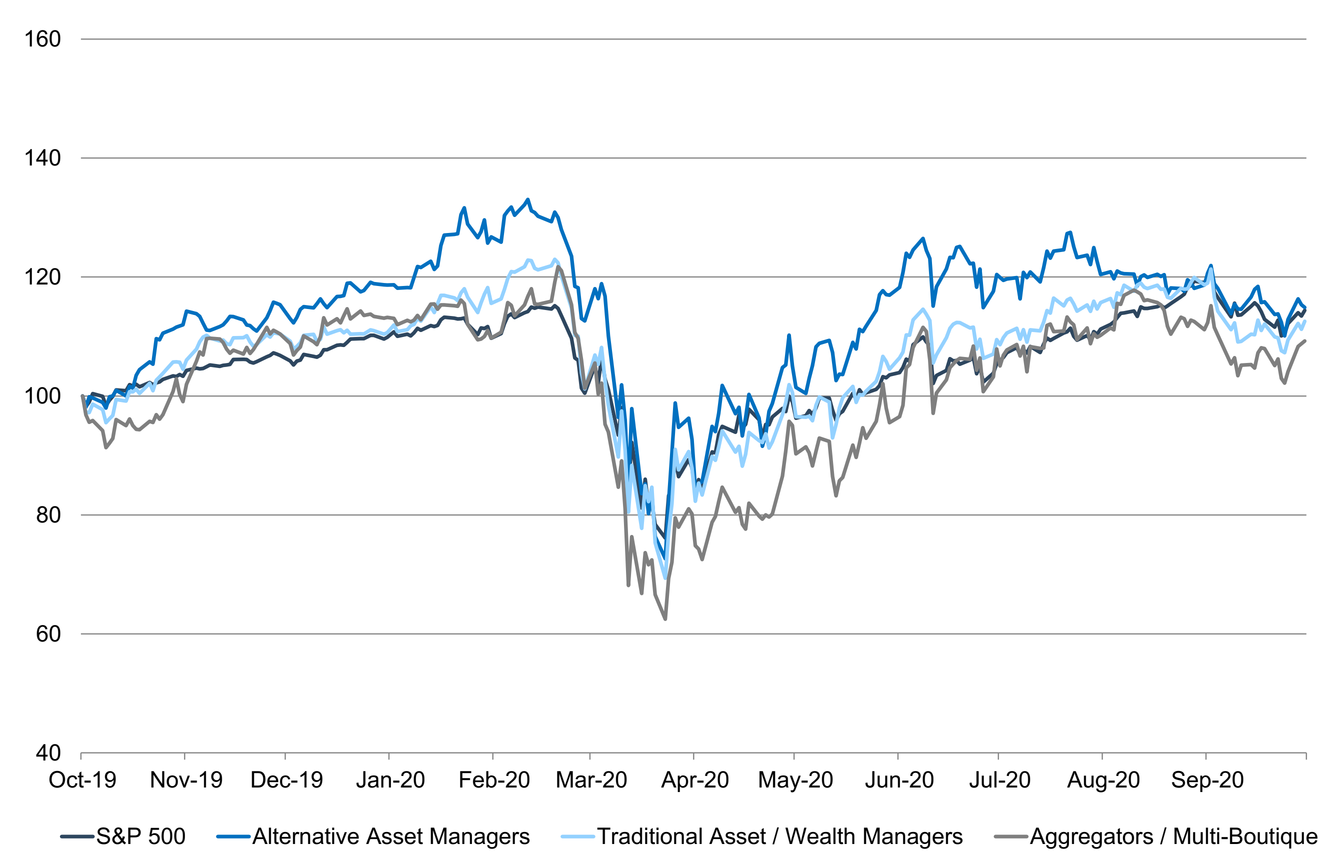
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Public Company Performance

Share prices for publicly traded investment managers trended upward during the second and third quarters after collapsing in mid-March coincident with a struggling market. Alternative asset managers fared comparatively well over the last year, as volatility and depressed asset prices created opportunity to deploy dry powder and raise new funds in several asset classes.

One driving force behind this growth is sustainable investments. While the last decade has been marked by outflows from actively managed funds to passive counterparts, **inflows to sustainable funds hit record highs**.

Some investors shifted funds to sustainable investments for moral reasons while others do so to lower financial risk. While sustainable investment managers originally sought to prove they could achieve similar market returns as traditional investments, the March 2020 market collapse strongly suggested that ESG investment strategies offer noncorrelated, equivalent upside potential and possibly lower downside exposure.



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Overview of Sustainable / Impact Investing

The definition of sustainable investing is wide-ranging. However, it is generally an investment approach that considers environmental, social, and governance (ESG) factors into the investment management process.

Negative screening	ESG integration	Corporate shareholder engagement & shareholder action	Norms-based screening	Positive best-in-class screening	Sustainable investing	Impact investing
Certain investments are excluded based on the company's specific ESG criteria	ESG factors are explicitly included in financial analysis	Investments are selected when shareholder engagement (directed by ESG factors) can influence corporate action	Investments are selected based on criteria set by international standards such as OECD, ILO, UN and UNICEF	Certain investments are selected because of ESG performance relative to industry peers	Includes sustainable investments such as clean energy, green technology, or sustainable agriculture	Investments are chosen because they solve social or environmental problem

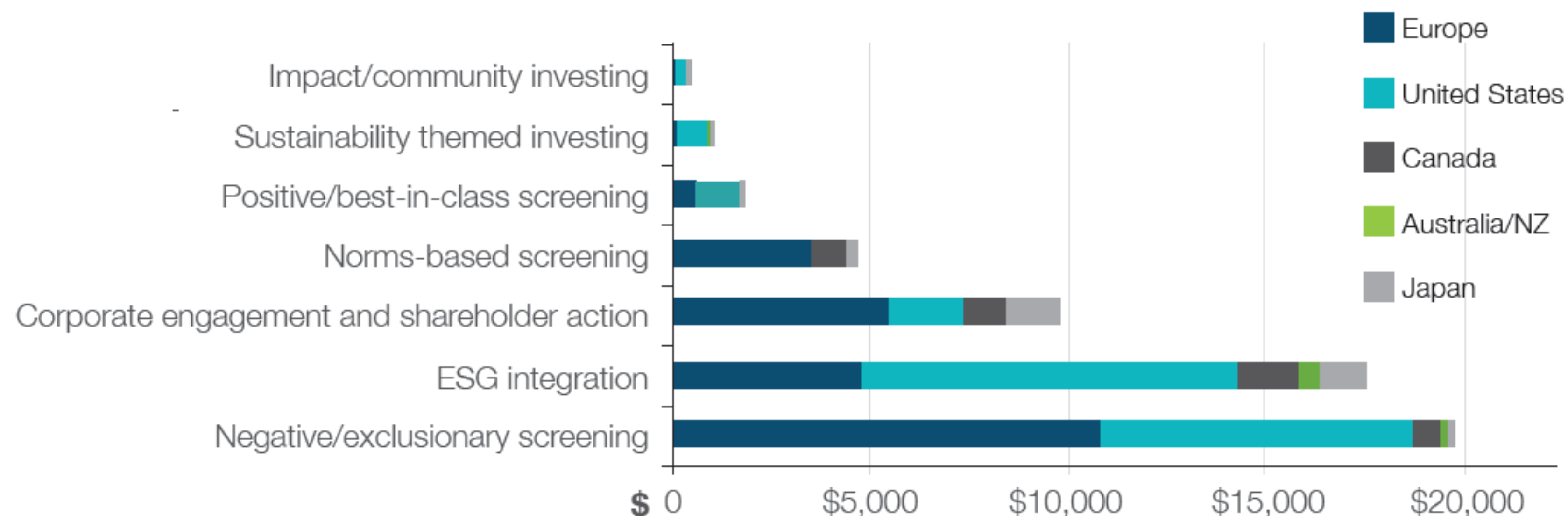
Based on definitions published in the Global Sustainable Investment Review 2012, which have emerged as a global standard of classification.

Sustainable Investing Strategy

Since 2012, the sustainable investment market has grown globally and each regions' approach to sustainable investing has evolved.

Negative screening is the most widely used form of sustainable investing, and also the most hands-off approach. Other methods such as corporate engagement and impact investing require more active involvement which generally commands higher fees.

Sustainable Investing Assets by Strategy & Region: 2018



Excerpt from the 2018 Global Sustainable Investment Review

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Can ESG Funds Improve Your RIA's Valuation?

Value is a function of cash flow, growth, and risk

$$V_0 = \frac{CF_1}{r - g}$$

Cash Flow	Sustainable investment strategies can be more expensive to run, resulting in lower margins
Growth	The growth of sustainable investment assets is expected to outpace traditional asset growth
Risk	Sustainable investments are thought to have less downside risk than traditional assets

The Key to Value Is Ultimately Distributable Cash Flow

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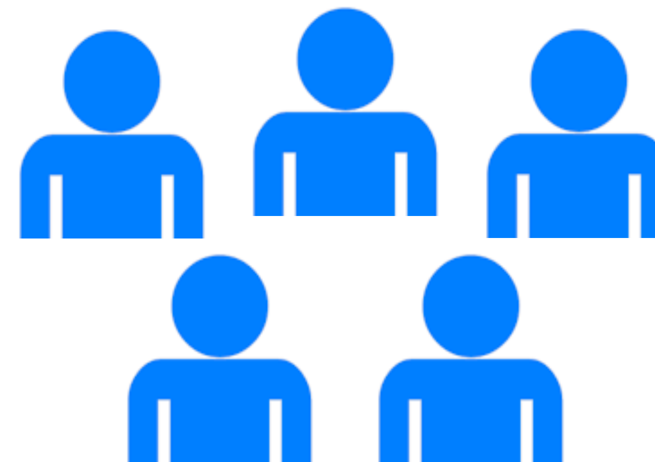
Can sustainable investment firms successfully pass higher costs through to the client?

Traditional asset manager EBITDA margins often range from about 25% to 45%. Most asset management firms have a significant amount of operating leverage available, and investments can typically be made in existing funds or familiar publicly traded securities and serviced by existing staff. Investment managers who employ negative screening and ESG integration have similar margins as traditional asset managers.

Corporate engagement and impact investing, in contrast, involve a more labor-intensive approach than traditional asset management. While there is little public information available about the cost of managing these strategies compared to traditional strategies, we have seen margins of sustainable investment firms generally fall below the typical range. Sourcing sustainable investment opportunities is a more complicated process than selecting publicly traded equities.

Consequently, sustainable investing firms are working to develop scalable platforms, and teams are learning to better communicate their value proposition to clients to justify charging higher fees.

Some forms of sustainable investing require more staff



Growth of Sustainable Investing

Higher growth prospects imply higher valuation per $1 of AUM

Sustainable Investing Assets				
(in billions)	**2014**	**2016**	**2018**	**CAGR (2014-18)**
Europe	$9,885	$11,045	$12,306	5.6%
United States	$6,572	$8,723	$11,995	16.2%
Canada (CAD)	$1,011	$1,505	$2,132	20.5%
Australia / New Zealand (in AUD)	$203	$707	$1,033	50.2%
Japan	¥840	¥57,056	¥231,952	307.6%

Per 2018 Global Sustainable Investment Review

Over the last decade, retail and institutional investors increased investment in sustainable strategies ranging from negative screening and ESG integration to impact investing. Global sustainable investment assets are estimated to have reached USD $30.7 trillion in 2018, up from $22.8 trillion in 2016.

The proportion of sustainable investing assets relative to total managed assets has been increasing in most regions of the world including the US, which saw an increase from 18% in 2016 to 26% in 2018 and Europe where sustainable investments make up approximately 50% of total professionally managed assets over this same time period.

While sustainable investing has grown in the U.S., the U.S. still lags Europe. Many argue this gap is due to a lack of options rather than a lack of interest. Approximately $30 trillion dollars is and will be transferred from baby boomers to their children (Gen X-ers and Millennials) over the coming years. Sustainable investment funds targeting U.S. investors appears poised for robust growth over the next decade.

The Business Case for Sustainable Investing

Lower risk implies higher valuations

According to the Global Sustainable Investment Review,

> ***Asset managers in the United States, Canada, Australia and New Zealand reported in regional surveys that major motivations for their use of sustainable investing strategies are the desire to minimize risk and improve financial performance over time.***

Lower downside risk can lower the implied volatility of an investment manager's revenues. However, even if investment managers can identify robust governance policies as an investment criteria, this does not necessarily correlate to having proper governance policies themselves.

Investment firms focusing on sustainable investments are still often riddled by many of the same risks traditional managers face, such as:

- Client concentrations
- Staff dependencies
- Lack of succession planning
- Striking the right balance between compensation and distributions
- Industry wide fee pressure

But, providing ESG options can mitigate certain risks such as generational connectiveness, as millennials and Gen X-ers are requiring investment options that align with their values.

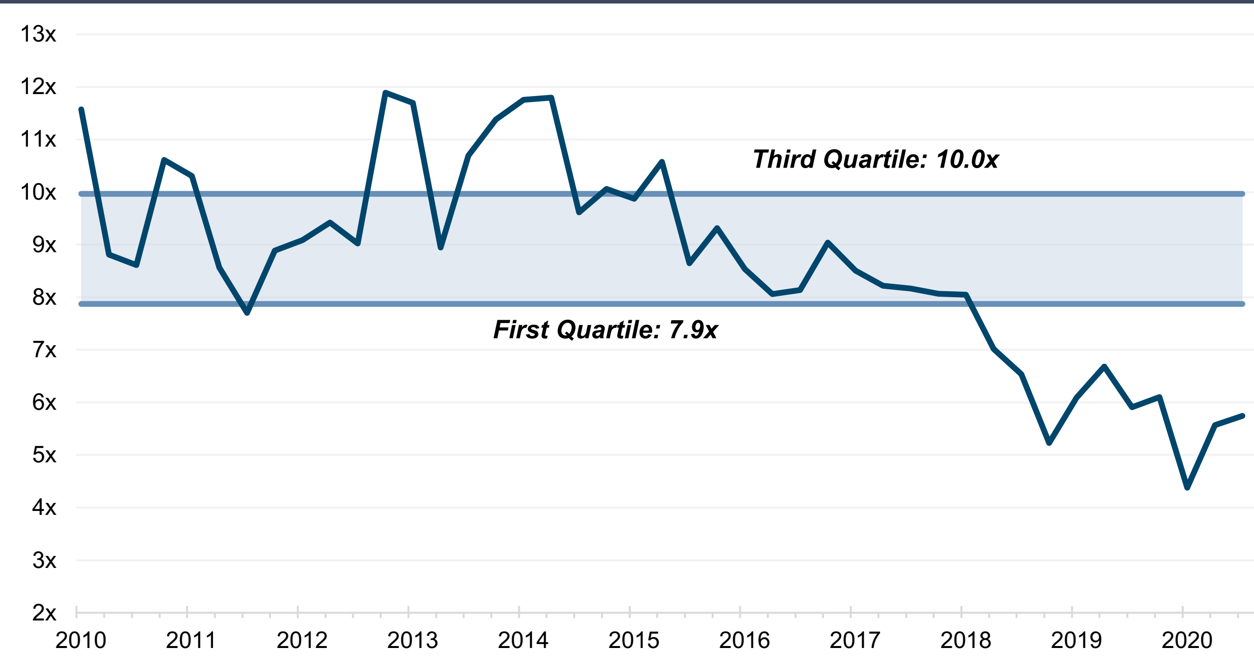
Implications for Your RIA

Publicly traded investment managers have historically priced on average in the 8-10x trailing EBITDA range. Since early 2018, EBITDA multiples for smaller publicly traded asset/wealth managers have trended downwards and remained below the historical range.

However, firms focused on sustainable investment approaches are typically valued at premium multiples.

While this could be partially due to the expectation that EBITDA margins will improve with continued inflows, the primary reason that firms focused on sustainable investments warrant premium pricing is the growth opportunity.

The movement of investable assets into sustainable strategies is expected to accelerate over the next decade. Is your firm positioned to participate in this growth?



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- Providing financial statement reporting services related to purchase price allocation and goodwill impairment testing
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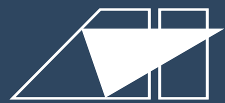

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