VALUE FOCUS

Investment Management

Second Quarter 2019 | Segment Focus: Trust Companies

In This Issue

Over the last year, traditional asset and wealth managers have trailed the market significantly. However, over the last quarter publicly traded asset and wealth manager stocks increased along with the broad market indices. The performance of asset and wealth management stocks over the quarter was supported by an improving price-to-earnings multiple, but multiples are still soft compared to historical norms.

While the broader investment management industry is facing headwinds from rising fee pressure, trust companies are somewhat protected from the decline in fees. In this issue's segment focus, we look at trust companies' shift to a directed trustee model, which allows the trust company to focus on fiduciary issues related to trust and estate administration rather than investment management.

Also in this issue, we address industry M&A trends and the factors driving deal activity, including increasing activity by RIA aggregators, rising cost pressures for asset managers, and increased attention to the wealth management space. Consolidation has been a driver of many of the recent large deals, as exemplified by Goldman Sachs's $750 million acquisition of RIA consolidator United Capital Partners.

Market Overview

Asset Management Stocks Find Some Relief after Year-end Rout

Publicly traded traditional asset and wealth managers ended the quarter up 6.2%, beating out the S&P 500 which rose 2.6%. Alt managers were the bright spot in the sector, up nearly 18%. Aggregators and multi-boutique model firms did not fare well despite all the hype about consolidation pressures in the industry and the **high-profile deals** in the aggregator space. These businesses ended the quarter down more than 14%.

Ordinarily, we'd expect investment manager stocks to outperform the S&P in a stock market rally, for the simple reason that higher AUM leads to higher revenue and an even greater increase in profitability with the help of operating leverage.

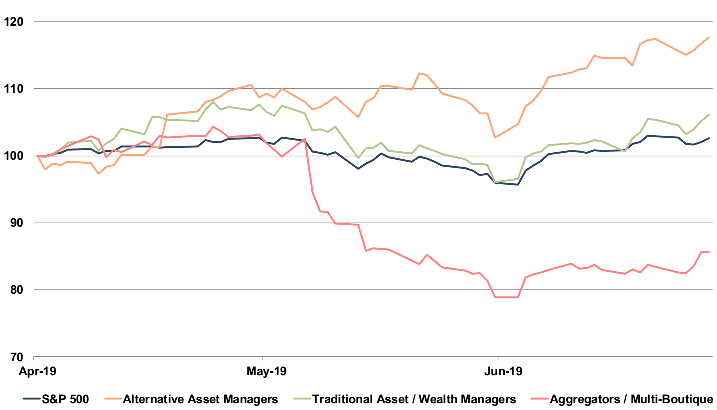
This was the case during the second quarter, when multiples continued to recover from December lows and profitability remained steady to improving. As a result, asset and wealth management stocks saw positive performance relative to the S&P 500 during the second quarter, as shown in Chart 1. Expand the chart over the last year, however, and the story for traditional asset and wealth managers looks less upbeat.

Over the last year, traditional asset and wealth managers trailed the market significantly. While the S&P 500 is up 8% over the last year, asset and wealth manager stocks are down 5%.

The asset and wealth management industry is facing numerous headwinds, chief among them being ongoing pressure for lower fees. Traditional asset and wealth managers feel this pressure acutely, which has likely contributed to their relative underperformance over the last year. Alt managers, which have been the sector's sole bright spot during this time, are more insulated from fee pressure due to the lack of passive alternatives to drive fees down.

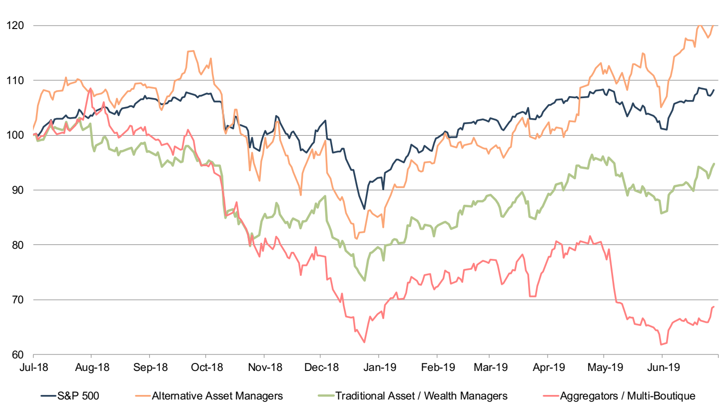
The aggregator and multi-boutique index declined over 30% during the last twelve months. Several firms in this category contributed to this decline, but the largest driver has been Focus Financial's major pullback from its lofty IPO price.

Chart 1 | Investment Management Performance by Sector: Q2 2019



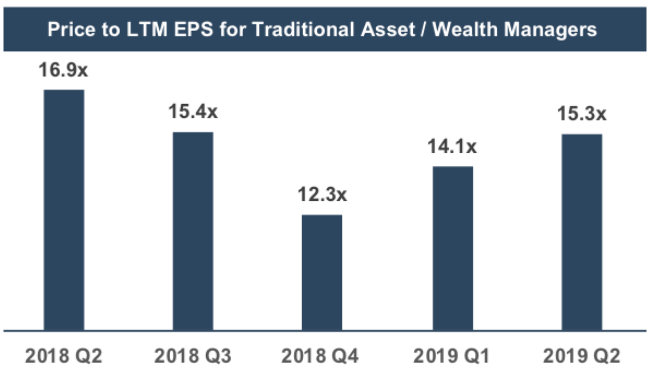
Source: S&P Global Market Intelligence

Chart 2 | Investment Management Performance by Sector: Twelve Months Ended June 30, 2019



Source: S&P Global Market Intelligence

The performance of asset and wealth management stocks over the quarter was supported by an improving price to earnings multiple. Multiples for publicly traded asset managers fell considerably near the end of 2018 as the broader equity markets pulled back. While there has been some rebound so far in 2019, multiples remain below the typical historical range.



Implications for Your RIA

The multiple expansion in the public markets combined with the expectation for stable-to-improving earnings given the movement in broad market indices suggests an improving outlook for privately held RIAs. If the public markets have relaxed a bit in pricing the industry headwinds, resulting in a higher multiple, then it is reasonable to assume that the same trend will have some impact on the pricing of privately held RIAs as well.

But the public markets are just one reference point that informs the valuation of privately held RIAs, and developments in the public markets may not directly translate to privately held RIAs. Depending on the growth and risk prospects of a particular closely held RIA relative to publicly traded asset and wealth managers, the privately held RIA can warrant a much higher, or much lower, multiple.

In our experience, the issues of comparability between small, privately held businesses and publicly traded companies are frequently driven by key person risk/lack of management depth, smaller scale, and less product and client diversification. These factors all contribute to the less-than-perfect comparability between publicly traded companies and most privately held RIAs. Still, publicly traded companies provide a useful indication of investor sentiment for the asset class, and thus, should be given at least some consideration.

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, though, is that RIAs are all impacted by the market. Their product is, after all, 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 managers and traditional asset managers are 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.

On balance, the outlook for RIAs appears to have improved since the end of 2018. The market has recovered following the Q4 correction, and multiples have trended upwards, although they remain below historical norms.

More attractive valuations could entice more M&A, coming off the heels of a record year in asset manager deal making. We'll keep an eye on all of it during what will likely be a very interesting year for RIA valuations.

Segment Focus: Trust Companies

Are Trust Companies Changing for the Better?

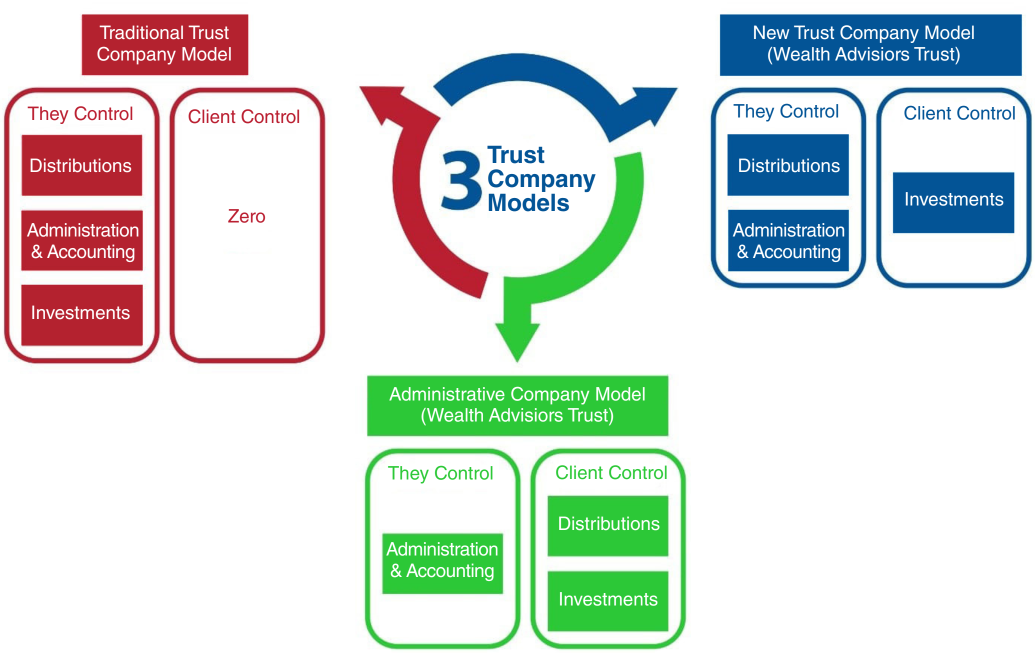
Trust law dates back to the 12th century, when landowners who left England to fight in the Crusades **retitled their property** to another trusted individual to manage the property until the crusader returned home. Upon returning home, however, the land title holder (the "trustee") often refused to return the property to the crusaders (the "beneficiary"). The Lord Chancellor typically ruled in favor of the returning crusader, requiring the title holder to return ownership of the land to the original holder. Hence, the foundation for modern trust law was formed.

Trust law has **evolved over time**, most recently with modern trust laws in the 1980s and 90s established by certain states such as Delaware, Nevada, and South Dakota. Other states, such as Tennessee, have developed compelling trust statutes in more recent years. Just as trust law has changed with the regulatory environment, trust companies are changing to meet clients' evolving needs.

As demand for trust company services increases with the generational transfer of wealth from baby boomers to their successors, trust companies are competing for new business by changing their model to better serve their clients and altering their marketing strategies to attract new assets.

A Fiduciary Minded Model

As depicted in the illustration below published by Wealth Advisors Trust Company, trust companies have traditionally managed the distribution, administration, and investment of trust assets. However, more trust companies are shifting to a **directed trustee model** which allows an investment advisor to be named on the account so that investment decisions are made by the appointed advisor rather than the trust company. This allows the trust company to focus on fiduciary issues related to trust and estate administration rather than investment management.



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, which 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 fiduciary and its investment advisor is responsible for investment decisions.

Increased Marketing Efforts

Trust companies have historically relied heavily on referrals for new clients. While the directed trustee model protects these referral relationships, many referral sources have been lost to industry consolidation. This has led trust companies to **increase their online marketing efforts.** Many of our clients have seen a reduction in referrals from their traditional referral sources and have responded by increasing spending on website upgrades and digital marketing.

Not only do marketing efforts generate new clients, but those clients tend to stick around. According to **Forbes**, 80% of trust company clients keep the same trustee for the life of the trust. This makes effective marketing essential for trust companies, because trust clients are sticky and once with another provider, a potential client has likely been lost for good.

Industry Tailwinds

Demand for trust company services has increased over the first half of the 2019 as "high-net-worth families **re-evaluate[d] their personal exposure to the market** and follow[ed] through on any big moves they've been putting off." This momentum in the industry is driving increased awareness of trusts as an important component of the financial planning process.

Additionally, industry participants generally believe that a large portion of the impending wealth transfer from baby boomers to gen X-ers and millennials will be left through real estate holdings, individual retirement accounts, and trusts; thereby providing a tailwind for the trust company industry.

Market Multiples

While there are no pure-play publicly traded trust companies, analysis of the public markets can lead to a better grasp of trust company valuations. Even though trust companies are increasingly outsourcing investment management, there are still a number of underlying similarities between the business models of trust companies and asset and wealth managers—the most notable being that revenue for all of these businesses is a function of assets under management. Because of the similarities, the market for asset and wealth management firms can offer some insight into valuation trends affecting trust companies.

Investment manager valuations have started to recover after stumbling in the first quarter following a rocky Q4 across the entire market. P/E multiples averaged approximately **15.3x LTM earnings** as of the end of 2Q 2019, up from 14.1x at the end of the 1Q 2019. The positive movement in asset and wealth manager multiples is likely to translate to some extent to trust companies as well, given the similarities between revenue models.

M&A Trends

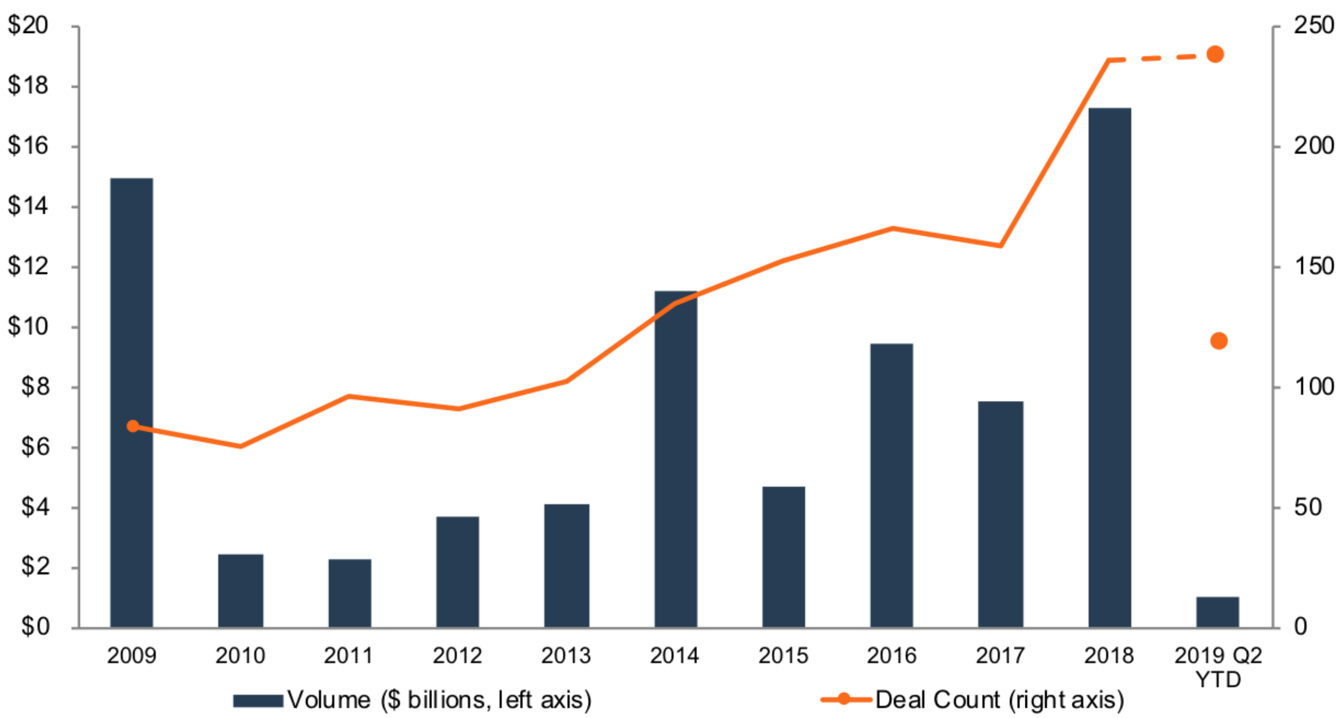
Asset and wealth manager M&A keeping pace with 2018's record levels

Through the first half of 2019, asset and wealth manager M&A has kept pace with 2018, which was the busiest year for sector M&A over the last decade. M&A activity in the back half of 2019 is poised to continue at a rapid pace, as business fundamentals and consolidation pressures continue to drive deal activity. Several trends which have driven the uptick in sector M&A in recent years have continued into 2019, including increasing activity by RIA aggregators and rising cost pressures.

Total deal count during the first half of the year is on pace to slightly exceed 2018's record levels. Reported deal value during the first half of 2019 was down significantly, although the quarterly data tends to be lumpy and many deals have undisclosed pricing.

Acquisitions by (and of) RIA consolidators continue to be a theme for the sector. The largest deal of the second quarter was **Goldman Sachs's $750 million acquisition** of RIA consolidator United Capital Partners. The deal is a notable bid to enter the mass-affluent wealth management market for Goldman Sachs. For the rest of the industry, Goldman's entrance into the RIA consolidator space is yet another headline that illustrates the broad investor interest in the consolidator model.

Asset Manager M&A (2008 – Q2 2019)



Source: Bloomberg
Transactions involving U.S.-based targets and buyers

If there was any doubt of that fact, just a few weeks ago **it was reported** that Mercer Advisors (no relation), an RIA consolidator managing $16 billion, is up for sale by its PE backer, Genstar Capital. Mercer could fetch an estimated $700 million price tag, putting it in a similar size bracket as the United Capital acquisition.

These RIA aggregators have themselves been active acquirers in the space, with Mercer Advisors and United Capital Advisors each acquiring multiple RIAs during 2018 and the first half of 2019.

The wealth management consolidator Focus Financial Partners (FOCS) has also been active since its July 2018 IPO, although acquisitions slowed during the second quarter of 2019. Focus announced a total of eight transactions during the second quarter, most of which were smaller sub-acquisitions by partner firms except for the acquisition of William, Jones & Associates, a New York based RIA managing $7 billion.

Sub-acquisitions by Focus Financial's partner firms and other firms owned by RIA consolidators are a growing M&A driver for the industry. These acquisitions are typically much smaller and are facilitated by the balance sheet and M&A experience of the consolidators. For some RIAs acquired by consolidators, the prospect of using buyer resources to facilitate their own M&A may be a key motivation for joining the consolidator in the first place. For the consolidators themselves, these deals offer a way to drive growth and extend their reach into the smaller RIA market in a way that is scalable and doesn't involve going there directly.

Consolidation Rationales

The underpinnings of the M&A trend we've seen in the sector include the lack of internal succession planning at many RIAs and the increasing importance of scale against a backdrop of rising costs and declining fees. While these factors are nothing new, sector M&A has historically been less than we might expect given the consolidation pressures the industry faces.

Consolidating RIAs, which are typically something close to "owner-operated" businesses, is no easy task. The risks include cultural incompatibility, lack of management incentive, and size-impeding alpha generation. Many RIA consolidators structure deals to mitigate these problems by providing management with a continued interest in the economics of the acquired firm while allowing it to retain its own branding and culture. Other acquires take a more involved approach, unifying branding and presenting a homogeneous front to clients in an approach that may offer more synergies, but may carry more risks as well.

Market Impact

Deal activity in 2018 was strong despite the volatile market conditions that emerged in the back half of the year. So far in 2019, equity markets have largely recovered and trended upwards. Publicly traded asset managers have lagged the broader market so far in 2019, suggesting that investor sentiment for the sector has waned after the volatility seen at year-end 2018.

M&A Outlook

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. The continuation of these trends will pressure RIAs to seek scale, which will in turn drive further M&A activity.

With over 13,000 RIAs currently operating in the U.S., the industry is still very fragmented and ripe for consolidation. 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 footprints and product offerings will also continue to be a key acquisition rationale as firms struggle with organic growth and margin compression. An aging ownership base is another impetus. The recent market volatility will also be a key consideration for both sellers and buyers in 2019.

Investment Manager Multiples by Sector

				Pricing as of June 29, 2019			
	Ticker	6/29/2019 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	141.72	70.9%	11.4x	nm	2.10	5.9x
GAMCO Investors, Inc.	GBL	19.17	67.7%	4.3x	nm	1.39	3.3x
Hennessy Advisors, Inc,	HNNA	9.70	54.0%	5.5x	nm	1.39	3.5x
Pzena Investment Management, Inc.	PZN	8.59	82.0%	11.1x	11.8x	1.79	8.3x
Silvercrest Asset Management Group	SAMG	14.03	76.8%	11.3x	12.0x	1.00	7.5x
Westwood Holdings Group, Inc.	WHG	35.20	56.8%	15.6x	nm	1.63	8.6x
Group Median			**69.3%**	**11.2x**	**11.9x**	**1.51**	**6.7x**
Traditional Asset / Wealth Managers (AUM Over $100B)							
AllianceBerstein Investments, Inc.	AB	29.72	94.6%	12.4x	12.2x	1.45	nm
BlackRock, Inc.	BLK	469.30	91.5%	18.0x	16.9x	1.16	13.3x
Eaton Vance Corp.	EV	43.13	79.2%	13.7x	13.0x	1.18	9.5x
Federated Investors, Inc.	FII	32.50	96.2%	15.2x	13.4x	0.74	9.9x
Franklin Resources, Inc.	BEN	34.80	97.2%	11.7x	13.6x	1.95	7.2x
Invesco Ltd.	IVZ	20.46	74.2%	8.9x	8.6x	1.67	13.2x
Legg Mason, Inc.	LM	38.28	99.9%	11.4x	29.8x	0.70	30.1x
T. Rowe Price Group, Inc.	TROW	109.71	87.5%	14.4x	14.3x	2.34	10.1x
Virtus Investment Partners, Inc.	VRTS	107.40	80.0%	9.7x	7.8x	0.55	6.6x
Waddell & Reed Financial, Inc.	WDR	16.67	77.1%	7.7x	10.4x	0.86	4.9x
Group Median			**89.5%**	**12.1x**	**13.2x**	**1.17**	**9.9x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	APO	34.30	94.0%	52.0x	14.2x	3.21	15.7x
Ares Management Corp	ARES	26.17	91.6%	172.3x	16.9x	8.21	19.2x
Associated Capital Group Inc	AC	37.40	79.8%	nm	nm	33.95	nm
Blackstone Group Inc/The	BX	44.42	97.3%	31.2x	19.6x	9.11	11.8x
Carlyle Group LP/The	CG	22.61	89.5%	10.6x	14.3x	4.29	9.4x
Cohen & Steers Inc	CNS	51.44	98.1%	20.8x	20.6x	3.97	14.8x
Hamilton Lane Inc	HLNE	57.06	98.3%	24.5x	30.4x	13.47	27.8x
KKR & Co Inc	KKR	25.27	88.0%	8.5x	15.0x	25.73	nm
Oaktree Capital Group LLC	OAK	49.54	97.6%	15.9x	13.9x	12.98	21.4x
Och-Ziff Capital Management Group Inc	OZM	22.96	99.2%	nm	6.7x	38.76	nm
Group Median			**95.7%**	**22.6x**	**15.0x**	**11.04**	**15.7x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	92.14	56.3%	12.4x	12.2x	1.06	9.3x
Artisan Partners Asset Management Inc.	APAM	27.52	77.5%	10.7x	10.2x	2.13	8.0x
Focus Financial Partners Inc	FOCS	27.31	55.2%	13.7x	13.0x	na	18.2x
Victory Capital Holdings Inc	VCTR	17.18	91.4%	15.2x	13.4x	2.61	10.5x
Group Median			**66.9%**	**13.1x**	**12.6x**	**2.13**	**9.89**
OVERALL MEDIAN			**88.8%**	**13.1x**	**13.6x**	**2.10**	**10.0x**

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 asset managers with annual ESOP valuations, fairness opinions, and appraisals for gift and estate tax compliance

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- Bank Trust Departments
- Broker-Dealers / Hybrid RIAs

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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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