VALUE FOCUS

Investment Management

Third Quarter 2019 | Segment Focus: Alternative Asset Managers

In This Issue

Publicly traded traditional asset and wealth management and alternative asset management stocks have generally increased with the market over the last nine months while aggregator stocks have declined. 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 quarter.

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. Most investors still value the diversification offered by alternative assets, particularly late in the economic cycle. In this issue's segment focus, we take a closer look at how alternative asset managers are performing in light of the broader shift from active to passive management and increased fee pressure.

Also in this issue, we address industry M&A trends and the factors driving deal activity. Through the first three quarters of 2019, asset and wealth manager M&A has kept up with 2018, the busiest year for sector M&A during the last decade. Acquisitions by RIA aggregators as well as sub-acquisitions by firms owned by RIA consolidators are drivers of M&A activity for the sector.

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Market Overview

Asset and Wealth Management Stocks Languish in Q3

Broad market indices were generally flat over the last quarter, while most categories of publicly traded asset and wealth manager stocks were off 5% to 10%. Our index of traditional asset and wealth managers ended the quarter down 5.4%, underperforming the S&P 500 which was up 0.4% over the same time. Aggregators and multi-boutique model firms declined 8.3%. Alt managers were the bright spot in the sector, up 3.5%.

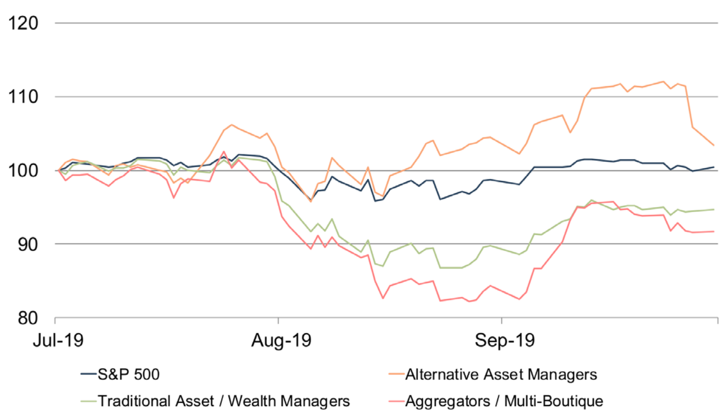
The headwinds, primarily fee pressure, faced by the asset and wealth management industry have contributed to a decline in EBITDA multiples for traditional asset / wealth managers, which in turn has resulted in lackluster stock price performance. As shown on the right, EBITDA multiples remain well below historical norms, although they have recovered somewhat from the low point seen in December 2018.

Expanding the performance chart over the last year reveals similar trends in asset / wealth manager performance relative to the broader market. Over this longer timeframe, alt managers are still the only category with positive returns, although performance has been volatile. Traditional asset / wealth managers generally moved in lockstep with the broader market until the third quarter of this year when relative performance declined significantly. Aggregators and multi-boutique have declined over 30%.

The 30+% decline in the aggregator and multi-boutique index may come as a surprise, given all the press about consolidation in the industry and headline deals for privately held aggregators. Over the last year, there have been two significant deals for privately held wealth management aggregators: **United Capital was bought** by Goldman Sachs for $750 million, and Mercer Advisors' PE backers sold a significant interest to a new PE firm, Oak Hill Capital Management. Both the United Capital and Mercer Advisors deals reportedly occurred at high-teens multiples of adjusted EBITDA.

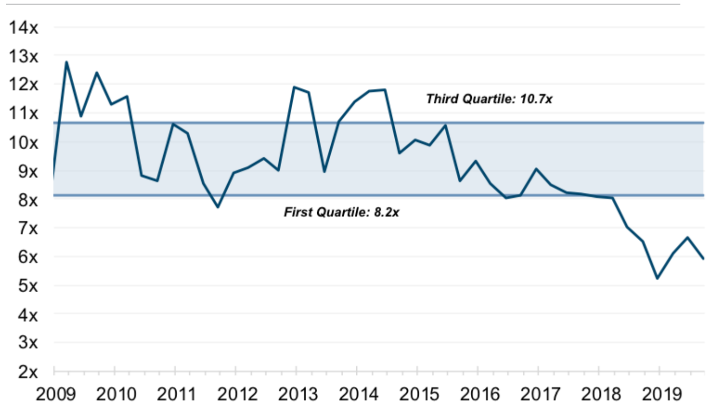
Meanwhile, stock of Focus Financial, a publicly traded wealth management aggregator, has declined significantly. At September 30, Focus stock closed at $23.80, about half its price a year prior and about 35% below the price at its July 2017 IPO.

Investment Management Performance by Sector: Q3 2019



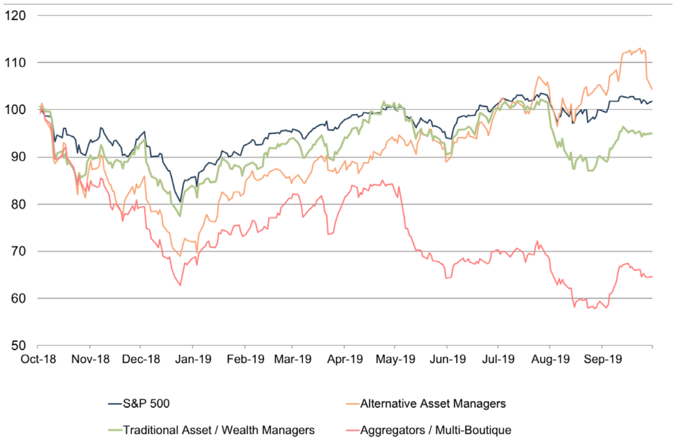
Source: S&P Global Market Intelligence

EV / EBITDA Multiples for Publically Traded RIAs under $100B AUM (2009 through 9/30/2019)



Source: Bloomberg

Investment Management Performance by Sector: Twelve Months Ended September 30, 2019



Source: S&P Global Market Intelligence

So why has Focus stock languished while Mercer Advisors and United Capital have both sold significant interests at attractive valuations? One explanation is different business models. The latter two firms are more "true" consolidators, where acquired firms are rebranded and integrated, then presented to the market as a coherent whole. Focus, on the other hand, is a pure financial consolidator. Acquired firms continue to operate as they did before the acquisition, and the only real difference (other than some back-office integration) is how the economics of the firm are distributed. There are pros and cons to each model, but given the poor performance of Focus Financial's stock since IPO, it appears the market may have grown skeptical of the purely financial consolidator strategy.

Implications for Your RIA

With EBITDA multiples for publicly traded asset and wealth managers still well below historical norms, it appears the public markets are pricing in many of the headwinds the industry faces. 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 and create synergies.

On balance, the outlook for RIAs appears to have improved since the significant market drop in December 2018. Since then, industry multiples have rebounded somewhat, and the broader market has recovered its losses and then some—which should have a positive impact on future RIA revenues and earnings.

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: Alternative Asset Managers

Alternative Asset Managers Resilient to Stock Price Declines

In May of this year, **assets in passively managed funds equaled assets actively managed** for the first time in history. As investors seek low-cost solutions, alternative managers are working to solidify their place in investors' portfolios.

While hedge funds are not a perfect proxy for the broader alternatives industry, we can better understand the pressure the industry faces by analyzing hedge fund asset flows. Hedge funds recorded their **fifth consecutive quarterly withdrawal** in Q2 2019 and the largest semiannual outflow ($47.4 billion) since the second half of 2016. Despite this, hedge fund assets under management grew 4.4% since the end of 2018, as positive performance offset fund flows. While hedge funds have underperformed over the last decade (since 2009 the S&P 500 index has dwarfed the performance of hedge funds as measured by the HFRI Fund Weighted Composite Index), recent volatility has improved their performance on a relative basis. Hedge Fund capital typically lags performance, so we expect to see asset outflows slow in the coming months as investors reallocate their portfolios in light of recent performance.

Alternative assets typically serve to either increase diversification or enhance portfolio returns. In a near zero interest rate environment, institutional investors have sought return generating assets. Over the last couple years, pension funds have started diversifying their portfolios to include alternative assets in order to chase higher risk, higher return assets. It is typically more difficult for the average investor to gain exposure to alternative assets due to the often significant minimum investment requirements. While some efforts have been made to expand distribution to the retail market, institutional investors are still the primary target market for alternative managers. Over the last several years, alternative asset managers have been largely successful at securing a spot in institutional investors' portfolios.

In terms of diversification, investors have started positioning themselves for longer term volatility due to increased geopolitical tensions and a slowing IPO market. While investor interest in uncorrelated asset classes such as alternatives fell during the longest bull market run in history, recent volatility could push investors back to the asset class.

Practice Management

Today, the main priority for most alternative asset managers is raising assets. Assets follow performance, especially in the alternatives space, and one way to directly impact investor returns is to reduce fees. After a decade of lackluster performance, reducing costs has become a key issue for alternative managers seeking to bring in new assets. Amidst fee pressure, alterative managers are deviating from the typical "2 and 20" model.

While traditional asset managers have been able to reduce fees by achieving some measure of scale, alternative managers must be careful to not sacrifice specialization in key strategies for scale. Alternative managers have seen some success utilizing technology in the front office or outsourcing certain functions in order to reduce overhead and spare time for management to focus on asset raising.

Industry Valuations

In the eyes of market participants, the industry has performed well over the last year. As explained above, alternative asset managers have generally been more resilient to price declines than traditional asset and wealth managers.

Price to LTM earnings multiples have recently increased for alternative asset managers as prices over the last year increased by a median of 16%. Current pricing is close to the 52-week high and forward multiples are noticeably lower than LTM multiples, suggesting that publicly traded alternative asset managers are trading at peak valuations currently and earnings are expected to increase over the next twelve months.

Despite improving performance over the last few years, the industry continues to face a number of headwinds, including fee pressure and expanding index opportunities. While the idea of **passively managed alternative asset products** seems like an oxymoron, a number of funds exist with a goal of imitating private equity returns. Innovative products are being made available to the investing public every day. And while there is currently no passive substitute to alternatives, we do believe that the industry will continue to be influenced by many of the same pressures that traditional asset managers are facing today despite the recent uptick in alt manager valuations.

M&A Trends

Asset and Wealth Manager M&A Keeping Pace with 2018's Record Levels

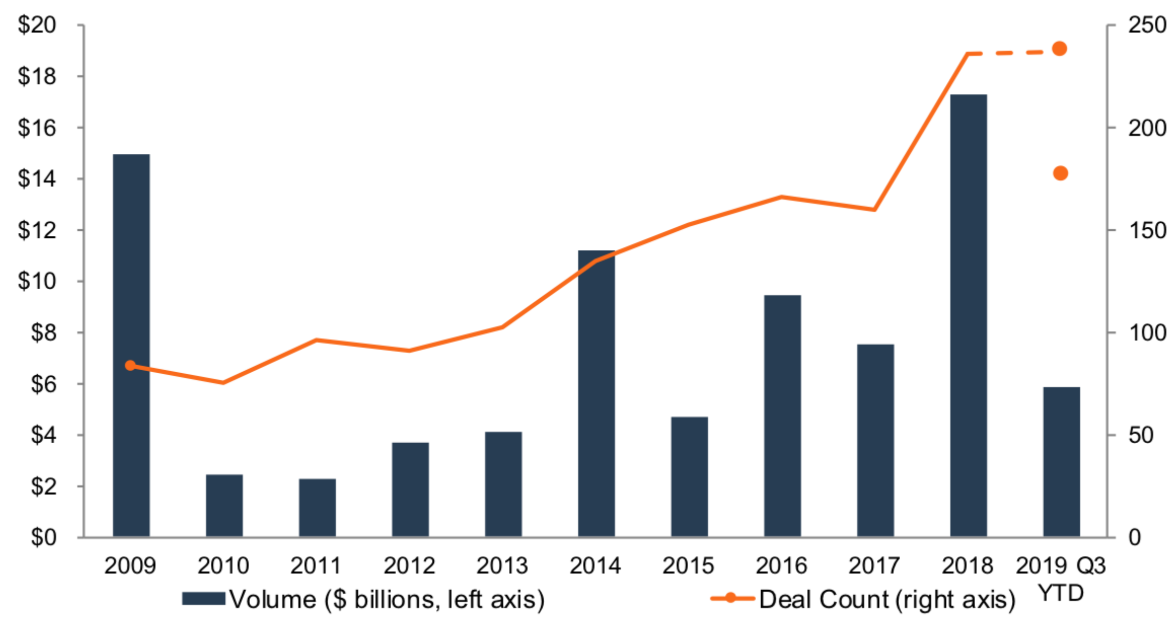
Transaction activity is poised to continue at a rapid pace, as business fundamentals and consolidation pressures continue to drive deal activity. Several trends which have driven the uptick in sector M&A in recent years have continued into 2019, including increasing activity by RIA aggregators and mounting cost pressures.

Total deal count during the first three quarters is set to exceed 2018's record levels. Reported deal value during the first three quarters was down, although the quarterly data tends to be lumpy and many deals have undisclosed pricing. Dollar value in 2018 was also boosted by Invesco's $5 billion purchase of OppenheimerFunds.

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 and yet one more approach to building a national RIA brand.

Mercer Advisors' **recent sale** to Oak Hill Capital Partners is further evidence of growing interest in the RIA consolidator space. While deal terms weren't disclosed, some industry analysts estimate a high teens EBITDA valuation that exceeded $500 million.

Asset Manager M&A (2009 – Q3 2019)



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

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 three quarters of 2019.

Sub-acquisitions by Focus Financial's partner firms and other firms owned by RIA consolidators are further drivers of M&A activity for the sector. 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

Building scale to enhance margins and improve competitive positioning are typical catalysts for consolidation, especially on the asset management side. One way to stem the tide of fee pressure and asset outflows is to cut costs through synergies to preserve profitability as revenue skids. The lack of internal succession planning is another driver as founding partners look to outside buyers to liquidate their holdings. While these factors are nothing new, sector M&A has historically been less than what 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 acquirers 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 following the correction at the end of last year.

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 will drive further M&A activity.

With over 11,000 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 buyers and sellers for the remainder of this year and the next.

Investment Manager Multiples by Sector

	Ticker	9/30/2019 Stock Price	% of 52 Week High	Pricing as of Sept. 30, 2019 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	138.13	76.9%	12.0x	nm	1.84	5.4x
GAMCO Investors, Inc.	GBL	19.55	81.1%	4.8x	nm	1.41	3.6x
Hennessy Advisors, Inc,	HNNA	10.81	72.2%	6.9x	nm	1.51	4.1x
Pzena Investment Management, Inc.	PZN	8.92	85.1%	11.9x	nm	1.80	8.7x
Silvercrest Asset Management Group	SAMG	12.30	76.7%	10.2x	9.8x	1.00	7.5x
Westwood Holdings Group, Inc.	WHG	27.67	52.9%	18.1x	nm	1.31	9.0x
Waddell & Reed Financial, Inc.	WDR	17.18	80.2%	8.4x	10.4x	1.83	5.9x
Group Median			**76.9%**	**10.2x**	**10.1x**	**1.51**	**5.9x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $100B)							
AllianceBerstein Investments, Inc.	AB	29.35	93.4%	12.5x	12.3x	1.40	nm
BlackRock, Inc.	BLK	445.64	91.4%	17.3x	16.3x	1.06	12.8x
Eaton Vance Corp.	EV	44.93	84.9%	13.9x	13.2x	1.48	12.4x
Federated Investors, Inc.	FII	32.41	90.1%	13.7x	13.1x	0.70	9.8x
Franklin Resources, Inc.	BEN	28.86	80.6%	10.0x	11.8x	1.54	6.1x
Invesco Ltd.	IVZ	16.94	71.9%	7.6x	7.0x	1.23	14.2x
Legg Mason, Inc.	LM	38.19	94.8%	11.3x	29.7x	0.77	44.9x
T. Rowe Price Group, Inc.	TROW	114.25	94.4%	14.5x	14.4x	2.34	10.5x
Virtus Investment Partners, Inc.	VRTS	110.57	87.4%	11.2x	8.0x	0.99	6.1x
Group Median			**90.1%**	**12.5x**	**13.1x**	**1.23**	**11.4x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	APO	37.82	90.5%	30.2x	16.0x	3.69	14.1x
Ares Management Corp	ARES	26.81	86.4%	26.9x	18.3x	8.25	19.2x
Associated Capital Group Inc	AC	35.59	75.9%	nm	nm	34.32	nm
Blackstone Group Inc/The	BX	48.84	88.5%	32.3x	21.8x	9.19	16.9x
Carlyle Group LP/The	CG	25.56	94.6%	8.8x	15.4x	3.04	5.2x
Cohen & Steers Inc	CNS	54.93	99.0%	22.1x	21.9x	4.13	14.6x
Hamilton Lane Inc	HLNE	56.96	88.1%	24.1x	30.4x	8.87	27.7x
KKR & Co Inc	KKR	26.85	89.6%	10.2x	15.8x	27.76	nm
Sculptor Capital Management Inc	SCU	19.48	76.4%	nm	5.2x	5.98	2682.3x
Group Median			**88.5%**	**24.1x**	**17.1x**	**8.25**	**16.9x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	83.35	59.8%	12.5x	12.3x	0.99	8.8x
Artisan Partners Asset Management Inc.	APAM	28.24	86.9%	11.1x	10.7x	2.10	nm
Focus Financial Partners Inc	FOCS	23.80	49.2%	13.9x	13.2x	na	17.4x
Victory Capital Holdings Inc	VCTR	15.38	81.8%	13.7x	13.1x	2.35	9.4x
Group Median			**70.8%**	**13.1x**	**12.7x**	**2.10**	**9.44**
OVERALL MEDIAN			**85.1%**	**12.5x**	**13.2x**	**1.81**	**9.8x**

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

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