VALUE FOCUS

Investment Management

Third Quarter 2020 | Segment Focus: Independent Trust Companies

In This Issue

In this issue, we review public market performance across the investment management industry in light of the COVID-19 global pandemic. The upward trend in publicly traded asset and wealth manager share prices since March is promising for the industry. AUM has risen with the market over this time, and it's likely that industry-wide revenue and earnings have as well. On balance, the outlook for RIAs has generally improved with market conditions over the last several months.

In our segment focus for this quarter, we look at the performance of independent trust companies. We explain how the performance of publicly traded investment managers can guide our understanding of trust company valuations even though there are no pure-play publicly traded trust companies. Overall, despite the global pandemic, the long-term outlook for most independent trust companies appears healthy.

Also in this issue, we address industry M&A trends and factors driving deal activity. In the midst of record high deal activity, we review our top four considerations when purchasing an RIA.

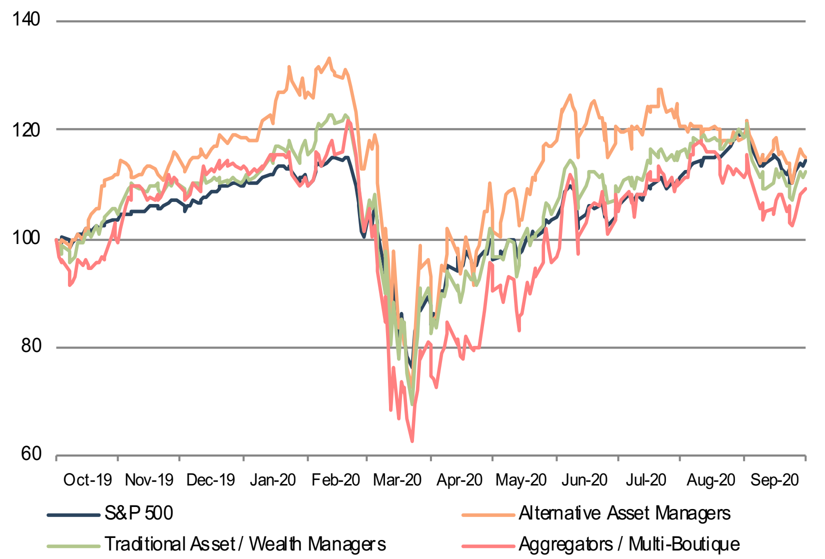
RIAs Continue to Rebound

Share prices for publicly traded asset and wealth managers have trended upward during the second and third quarters after collapsing in mid-March with the broader market. Alternative asset managers have fared well over the last year as volatility and depressed asset prices have created opportunity to deploy dry powder and raise new funds in certain asset classes. Traditional asset and wealth managers have generally moved in line with the broader equity market, while leveraged RIA aggregators have seen more volatility, both up and down, as the market bottomed in March before trending upward.

Looking at the third quarter, traditional asset and wealth managers and aggregators trended upwards in July and August before pulling back as the market dipped in September. While the quarter was volatile, both of these categories ended up about 4%. The primary driver behind the increase was the market itself, as most of these businesses are primarily invested in equities, and the S&P 500 gained about 8% over the quarter.

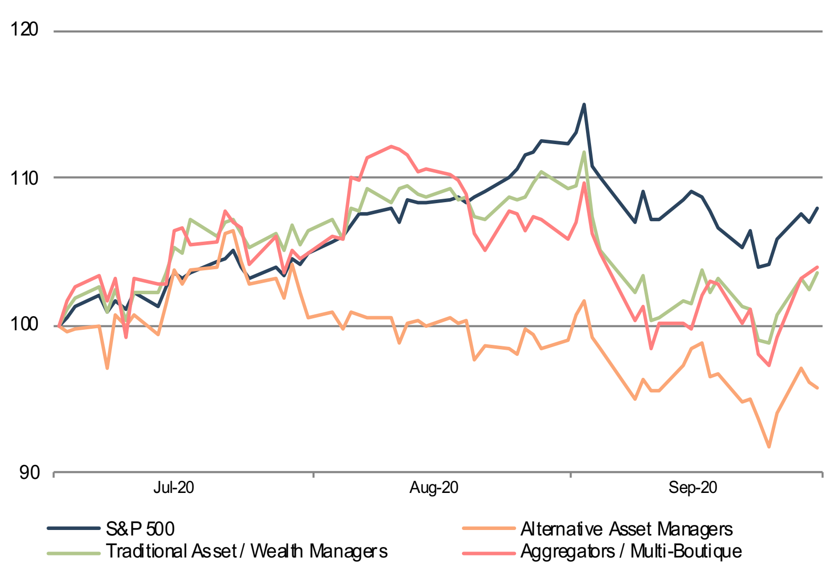
The upward trend since March in publicly traded asset and wealth manager share prices is promising for the industry, but it should be evaluated in the proper context. Pre-COVID, the industry was already facing numerous headwinds including fee pressure, asset outflows, and the rising popularity of passive investment products. While the 11-year bull market run largely masked these issues, asset outflows and revenue pressure can be exacerbated in times of market pullbacks and volatility.

Investment Manager Performance by Sector - LTM ended 9/30/2020



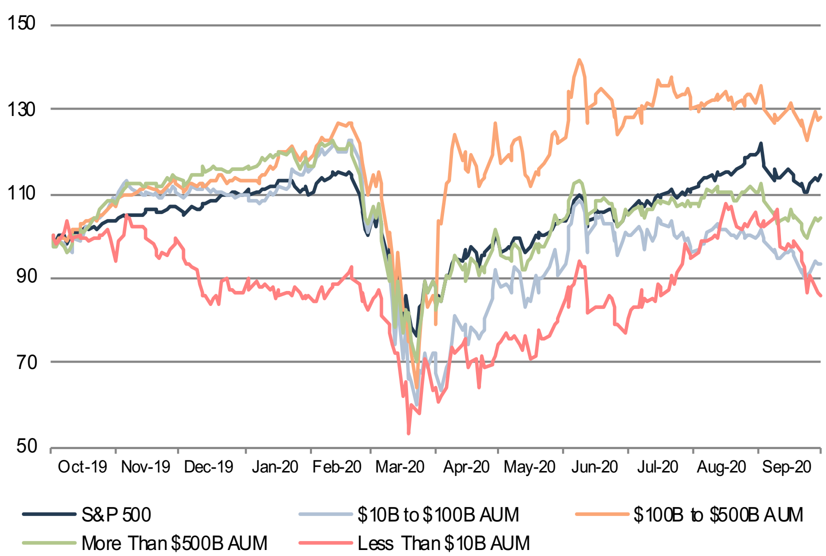
Source: S&P Global Market Intelligence

Investment Manager Performance by Sector - Q3 2020



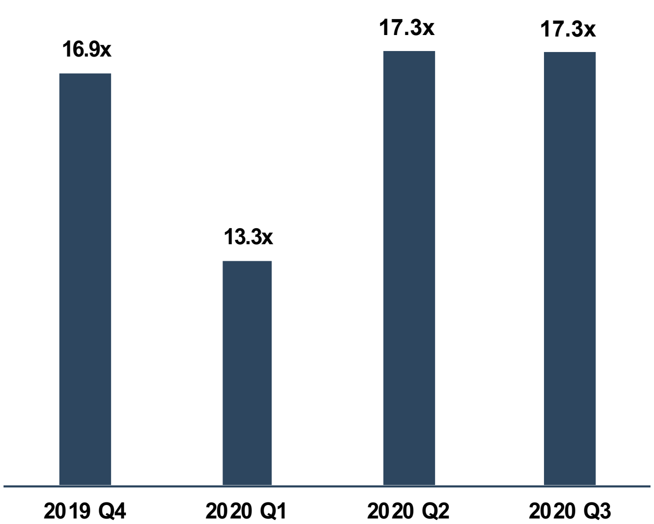
Source: S&P Global Market Intelligence

Investment Manager Performance by AUM Size - LTM ended 9/30/2020



Source: S&P Global Market Intelligence

Price to LTM EPS
Traditional Asset / Wealth Managers



Source: S&P Global Market Intelligence

Smaller publicly traded asset and wealth managers have been most affected by these trends, which is reflected in their share price performance over the last year. As shown in the figure to the left, asset and wealth managers with more than $100 billion AUM have performed well over the last year, with the $100 - $500 billion AUM group up 28% and the $500 billion+ group up 4%. Smaller RIAs, those with under $100 billion AUM, have been down over the last year, with the smallest group (under $10 billion AUM) down 14%.

As valuation analysts, we're often interested in how earnings multiples have evolved over time since these multiples reflect market sentiment for the asset class. LTM earnings multiples for publicly traded asset and wealth management firms declined significantly during the first quarter—reflecting the anticipation of lower earnings due to large decreases in AUM—but have since recovered in the second and third quarters as prospects for earnings growth have improved.

Implications for Your RIA

During such volatile market conditions, the value of your RIA is sensitive to the valuation date or date of measurement. In all likelihood, the value declined with the market in the first quarter before recovering most of that loss in the second and third quarters. We've been doing a lot of valuation updates amidst this volatility, and there are several factors we observe in determining an appropriate amount of appreciation or impairment.

One is the overall market for RIA stocks, which was down significantly in the first quarter but has since recovered to above where it was a year ago. The P/E multiple is another reference point, which has followed a similar path. We apply this multiple to a subject RIA's earnings, so we also have to assess how much that company's annual AUM, revenue, and cash flow have increased or diminished since the last valuation, while being careful not to count good or bad news twice.

While the market for publicly traded companies is one data point that informs private RIA valuations, that's not to say that privately held RIAs have followed the same trajectory as their smaller public counterparts. Many of the smaller publics are focused on active asset management, which has been particularly vulnerable to the headwinds previously discussed. Many smaller, privately held RIAs, particularly those focused on wealth management for HNW and UHNW individuals, have been more insulated from industry headwinds, and the fee structures, asset flows, and deal activity for these companies have reflected this.

We also evaluate how our subject company is performing relative to the industry as a whole. Fixed income managers, for instance, held up reasonably well compared to their equity counterparts in the first quarter. We also look at how much of a subject company's change in AUM is due to market conditions versus new business development net of lost accounts. Investment performance and the pipeline for new customers are also key differentiators that we keep a close eye on.

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.

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 manager valuations are tied to the demand from consolidators while traditional asset managers are more 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 with cheap financing.

On balance, the outlook for RIAs has generally improved with market conditions over the last several months. AUM has risen with the market over this time, and it's likely that industry-wide revenue and earnings have as well. The third quarter was generally a good one for RIAs, but who knows where the last quarter of 2020 will take us.

Segment Focus: Independent Trust Companies

Outlook During COVID-19

As with other industries, trust company revenue can be broken down into price and quantity. In the context of trust companies, quantity is measured by the value of AUA and price is measured by the realized fee structure. The recent coronavirus induced sell-off had a negative impact on the top line for trust companies, as it did for all investment managers that charge a percentage of assets under management. However, prices for most risk assets have recovered from late-March levels and unlike many asset and wealth management firms, trust companies often have revenue sources that aren't based on AUM/AUA (e.g., tax planning, estate administration fees) which provides some protection during market downturns.

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 is a function of assets under management/administration. Because of the similarities, the market for asset and wealth management firms can offer some insight into valuation trends affecting trust companies. Since early 2018, EBITDA multiples for smaller publicly traded investment managers have trended downwards and remained below the historical range. This decline reflects adverse trends like pricing pressure and asset outflows that have impacted this group of public companies (which consists predominately of asset managers). Many sectors of closely held RIAs, particularly wealth managers, as well as larger public asset and wealth managers have been less impacted by these trends and have seen more resilient multiples as a result.

With the advent of COVID-19 and the resulting equity market downturn in the first quarter of 2020, trailing EBITDA multiples for publicly traded RIAs declined to historic lows before rebounding in the second and third quarters as markets recovered. 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.

Outlook for Independent Trust Companies

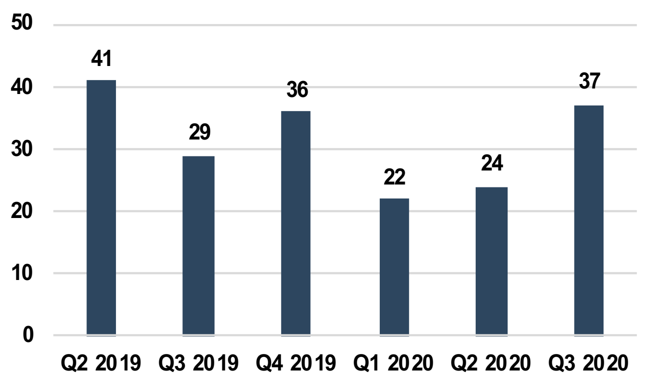
Many trust companies have performed remarkably well over the last decade, aided by the recently ended 11-year bull market and the trends previously discussed. The current market environment is one of incredible uncertainty, and the outlook for trust companies and the economy as a whole will continue to evolve rapidly over the coming months. Trust companies could be aided by the recent uptick in estate planning spurred by the 2020 presidential election and the prospect for adverse changes to estate tax laws.

RIA M&A Amid COVID-19

Deal Activity Back to Record Highs

COVID-19 adversely affected sector M&A for a couple months when most of the U.S. was under shelter at home/ safer in place orders; however, deal activity recovered quickly. **Fidelity reported** that half of all deals reported in September were for firms with over $1 billion in AUM and approximately $48 billion in total assets were acquired in the third quarter of 2020, the most ever recorded since Fidelity began tracking wealth management M&A in 2016.

M&A Transactions by Quarter



Source: Fidelity Wealth Management M&A Transaction Reports

There are several often overlooked deal considerations buyers of RIAs should be apprised of prior to purchasing a wealth management firm. We've outlined our top four considerations when purchasing RIAs in today's environment:

1. **Price.** With most of the domestic equity markets back to near-peak levels, the financial commitment required to purchase a wealth management firm has likely increased in recent months, lowering the prospective ROI of an acquisition. We often see some temptation to pay a higher earnings multiple based on rule-of-thumb activity metrics (% of AUM or revenue), but we would typically advise against paying above normal multiples of ongoing EBITDA for a closely held RIA, absent significant synergies or growth prospects for the target company.

2. **Structure.** Since many wealth management firms are heavily dependent upon a few staff members for key client relationships, many deals are structured with earn-out components to support business continuity following the transaction. The earn out period tends to be two to three years with a third to half of the total consideration paid out based on future growth and client retention. COVID-19's impact on the markets and economy has elevated the demand for buyer protection, and many buyers are now requiring larger earn-out components to protect themselves from future downturns or client attrition.

3. **Culture.** It's hard to know how the cultures of firms in any industry will mesh after a merger, and this side of due diligence has been most affected by COVID-19 as in-person meetings are still generally being avoided. The culture issue is especially true for bank acquisitions of wealth management firms. Compensation, work habits, client service expectations, and production goals can vary, so it's important to consider if these discrepancies could become problematic when the firms join forces. **We've seen culture clashes blow up deals that looked great on paper**.

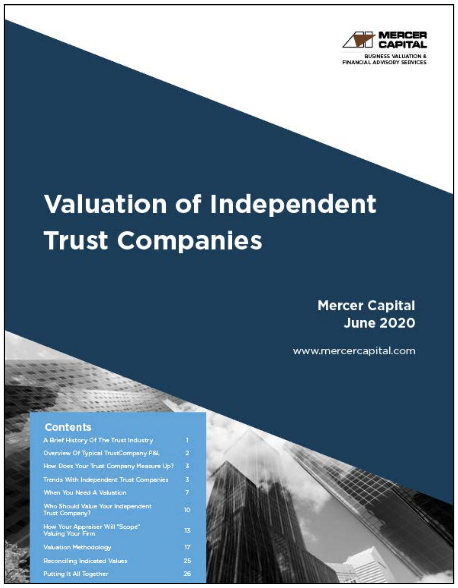
4. **Degree of Operational Autonomy.** Wealth managers (and their clients) value independence. Individual investors typically must consent to any significant change in ownership to retain their business following a transaction and may not be willing to do so if they feel that their advisor's independence is compromised. Senior managers at the target firm will likely need to be assured that the new owner will exert minimal interference on operations and strategic initiatives if key personnel are to be retained.

Webinar Recording

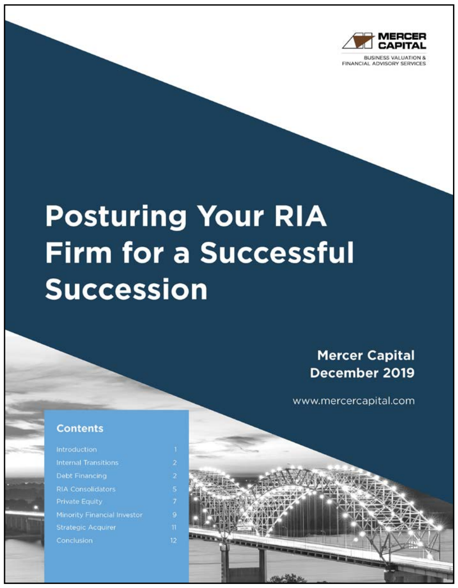
In this September 23, 2020 webinar, Matt Crow and Taryn Burgess explain valuation considerations for independent trust companies and why common rules of thumb don't always work.

WATCH

RIA Whitepapers



DOWNLOAD



DOWNLOAD

Investment Manager Multiples by Sector

	Ticker	9/30/2020 Stock Price	% of 52 Week High	Price / Trailing EPS	Price / Forward EPS	Enterprise Value / AUM (%)	Enterprise Value / EBITDA
				Pricing as of September 30, 2020			
TRADITIONAL ASSET / WEALTH MANAGERS (AUM UNDER $100B)							
Diamond Hill Investment Group, Inc.	DHIL	126.32	84.2%	10.6x	nm	1.49	5.8x
GAMCO Investors, Inc.	GBL	11.57	58.2%	4.2x	nm	0.99	3.2x
Hennessy Advisors, Inc,	HNNA	8.29	64.9%	7.0x	nm	1.49	4.0x
Pzena Investment Management, Inc.	PZN	5.36	58.0%	nm	nm	1.33	13.6x
Silvercrest Asset Management Group	SAMG	10.46	76.1%	9.2x	8.0x	1.00	5.7x
Westwood Holdings Group, Inc.	WHG	11.14	34.9%	41.5x	nm	0.49	10.9x
Waddell & Reed Financial, Inc.	WDR	14.85	84.2%	9.6x	10.1x	1.56	6.3x
Virtus Investment Partners, Inc.	VRTS	138.65	93.5%	10.4x	8.9x	1.06	4.7x
Group Median			**70.5%**	**9.6x**	**8.9x**	**1.19**	**5.7x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $100B)							
AllianceBerstein Investments, Inc.	AB	27.04	75.0%	10.1x	10.1x	1.30	6.2x
BlackRock, Inc.	BLK	563.55	92.4%	19.9x	18.7x	1.23	14.9x
Eaton Vance Corp.	EV	38.15	73.7%	13.2x	11.4x	1.13	9.7x
Federated Investors, Inc.	FHI	21.51	56.2%	7.2x	7.7x	0.36	5.5x
Franklin Resources, Inc.	BEN	20.35	69.5%	9.0x	7.9x	1.03	3.9x
Invesco Ltd.	IVZ	11.41	60.0%	5.6x	7.1x	1.21	11.1x
T. Rowe Price Group, Inc.	TROW	128.22	90.0%	15.2x	14.7x	2.32	10.5x
Group Median			**73.7%**	**10.1x**	**10.1x**	**1.21**	**9.7x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	APO	44.75	80.8%	nm	23.9x	3.87	nm
Ares Management Corp	ARES	40.42	95.3%	18.9x	23.8x	10.13	nm
Associated Capital Group Inc	AC	36.13	55.2%	nm	nm	61.86	nm
Blackstone Group Inc/The	BX	52.20	80.3%	52.5x	25.9x	9.18	nm
Carlyle Group LP/The	CG	24.67	70.5%	nm	14.4x	4.72	nm
Cohen & Steers Inc	CNS	55.74	71.3%	21.5x	23.2x	4.00	16.7x
Hamilton Lane Inc	HLNE	64.59	84.6%	35.3x	34.1x	8.91	27.3x
KKR & Co Inc	KKR	34.34	92.4%	nm	21.8x	20.54	nm
Sculptor Capital Management Inc	SCU	11.74	40.7%	nm	12.4x	4.60	nm
Group Median			**80.3%**	**28.4x**	**23.5x**	**8.91**	**22.0x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	68.38	76.9%	27.5x	5.7x	1.02	8.2x
Artisan Partners Asset Management Inc.	APAM	38.99	97.3%	15.4x	12.5x	2.66	10.4x
Focus Financial Partners Inc	FOCS	32.79	80.0%	26.7x	11.2x	na	13.8x
Victory Capital Holdings Inc	VCTR	16.89	68.0%	5.9x	4.7x	1.51	6.6x
Group Median			**78.4%**	**21.1x**	**8.4x**	**1.51**	**9.30**
OVERALL MEDIAN			**75.5%**	**11.9x**	**11.9x**	**1.49**	**8.2x**

Source: Bloomberg

MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

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

- Registered Investment Advisors
- Money Managers
- Wealth Management Firms
- Mutual Fund Companies
- 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

- Corporate Valuation
- Fairness Opinions
- M&A Representation & Consulting
- Buy-Sell Agreement Valuation & Consulting
- Financial Reporting Valuation
- Tax Compliance Valuation
- Litigation & Dispute Resolution Consulting/ Testimony
- ERISA Valuation

Mercer Capital's Investment Management Industry Team

Matthew R. Crow, ASA, CFA
901.322.9728
crowm@mercercapital.com

Brooks K. Hamner, CFA, ASA
901.322.9714
hamnerb@mercercapital.com

Zachary W. Milam, CFA
901.322.9705
milamz@mercercapital.com

Taryn E. Burgess, CFA, ABV
901.322.9757
burgesst@mercercapital.com

Mercer Capital

www.mercercapital.com