MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

VALUE FOCUS

Investment Management

Fourth Quarter 2020 | Segment Focus: Asset Managers

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 Q1 is promising for the industry. AUM has risen with the market over this time, and with it, so has industry-wide revenue and earnings. On balance, the outlook for RIAs has generally improved with market conditions in the last three quarters of 2020.

In our segment focus for this quarter, we look at the performance of asset managers. We consider why the multiples observed in acquisitions of asset managers are lower than wealth managers and explain how small / mid-sized asset managers stay relevant after a decade of passive outperformance.

Also in this issue, we address industry M&A trends and factors driving deal activity. Record deal activity was driven by consolidators' acquisition of wealth managers and strategic acquisitions of large asset managers and discount brokerages.

RIAs Continue to Rebound

Share prices for publicly traded investment managers have trended upward with the market since March's collapse. Aggregators have fared particularly well over the last nine months on low borrowing costs and steady gains on their RIA acquisitions. Traditional asset and wealth managers have also performed well over this time, befitting from rising AUM balances and favorable market conditions.

The upward trend in publicly traded asset and wealth manager share prices since March 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.

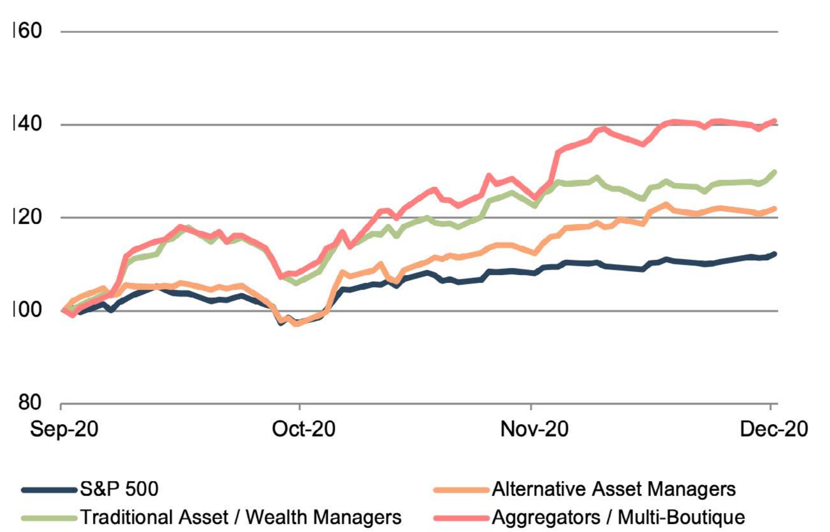
The fourth quarter was also favorable for publicly traded RIAs of all sizes except the under $10 billion in AUM category. This underperformance is largely attributable to the lack of diversification in this index and one company's (Hennessy Advisors) earnings misses rather than any indication that smaller RIAs have struggled over the last few months.

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 market's anticipation of lower earnings due to large decreases in client assets attributable

Investment Manager Performance by Sector - LTM ended 12/31/2020

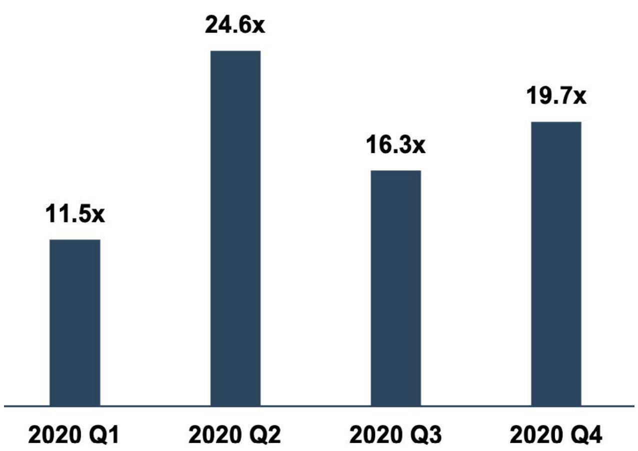
Source: S&P Global Market Intelligence

Investment Manager Performance by Sector - Q4 2020



Source: S&P Global Market Intelligence

Price to LTM EPS
Traditional Asset / Wealth Managers



Source: S&P Global Market Intelligence

to COVID-19's impact on the market. Multiples were inflated in Q2 as prices recovered and earnings lagged. Metrics have since normalized as prospects for earnings growth have improved with AUM balances.

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 and has now recovered most or all of that loss. 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 (see chart above). 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 larger public counterparts. Many of the smaller publics are focused on active asset management, which has been particularly vulnerable to the headwinds discussed previously. 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 of 2020. Additionally, 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 fourth quarter was generally a good one for RIAs, but who knows where 2021 will take us following a wild year for RIA valuations and market conditions.

Segment Focus: Asset Managers

Small / Mid-Sized Asset Managers Can Stay Relevant

Over the last decade, investors have generally earned a higher net return by investing in passive vehicles rather than actively managed funds. Heather Brilliant, CFA (CEO of Diamond Hill), says the growth of passive investing has allowed **"investors to access beta at a much lower price."**

However, the strong performance of large cap indices like the S&P 500 between the 2008-2009 recession and February of this year has also contributed to outflows from actively managed products. In March of last year, when the stock market fell due to COVID-19, many of our clients thought this would lead to a reversal in the trend. Active managers could once again shine.

Exhibit 6 Estimated Net Flows by Active/Passive: U.S. Category Groups

U.S. Category Group	Active Nov. 2020 ($Mil)	Active TTM ($Mil)	Active Assets ($Bil)	Passive Nov. 2020 ($Mil)	Passive TTM ($Mil)	Passive Assets ($Bil)
U.S. Equity	(13,554)	(259,313)	5,008	49,111	33,838	5,429
Sector Equity	2,114	(10,343)	451	17,547	44,598	631
International Equity	(2,720)	(96,744)	2,120	9,014	44,536	1,469
Allocation	(2,437)	(81,448)	1,351	431	289	10
Taxable Bond	28,581	192,031	3,244	23,515	220,537	1,768
Municipal Bond	6,261	42,173	863	1,916	11,184	58
Alternative	(1,016)	(9,904)	135	(1,605)	17,672	77
Commodities	(404)	(3,097)	24	(4,767)	39,299	131
All Long Term	16,827	(226,644)	13,196	95,164	411,953	9,573

Source: Morningstar Direct Asset Flows. Data as of Nov. 30, 2020. TTM is trailing 12 months.

When the market quickly recovered and performance was largely driven by a handful of sizeable tech companies, however, active managers continued to struggle to deliver alpha (net of fees). **U.S. trailing twelve month fund flows** as of November 2020 were negative for all classes of actively managed equity investments and positive for all passive products. Passive market share is now greater for U.S. equity investing than active, a first.

While large asset managers (i.e. BlackRock), are protected by sheer scale, how do small / mid-sized asset managers stay relevant in this environment?

As we explain later in this newsletter, the multiples observed for publicly traded asset managers are often lower than multiples observed in acquisitions of wealth management franchises. Asset managers are still facing numerous headwinds, as outlined in the table to the right, and this higher risk profile and lower opportunity for growth is the cause for lower multiples.

INDUSTRY HEADWIND	HOW TO STAY RELEVANT
Underperformance Drives Outflows An asset manager's clients are more likely to jump ship after short term underperformance than clients of wealth managers. **A 2016 State Street Study** found that 89% of clients will look elsewhere after just 2 years of underperformance. Outperformance can also drive asset attrition from rebalancing.	**Educate your Clients** Investors who truly understand the risk/ return profile of their investment portfolio are more likely to tolerate short term underperformance. Most asset managers have a style that will work better in some markets than others.
Asset Management Industry Barbell Many asset managers are too small to achieve scale yet too big for the investment team to create highly researched and distinguished funds. Some of these firms are capitulating to consolidation, but there are other options.	**Commit to Capacity Limits** The CEO of Diamond Hill Capital Management, Heather Brilliant, CFA, took the stance **in a recent podcast** that active management is not a scale game. While many consider this to be a shortcoming of the industry, acknowledging that your firm cannot work for everyone, but can deliver great returns for fewer investors, is key. Her advice lines up with the recent growth of the OCIO industry, which commits more time and energy to individual clients' needs.
Fee Pressure As we have written numerous times before, fee pressure in the asset management space has increased over the last decade, as low-to-no-cost products have proliferated and actively managed products have underperformed.	**Differentiate Products and Trim Expenses** There are two ways to increase the bottom line: 1) increase revenue and 2) reduce expenses. Asset managers can combat fee pressure by differentiating their products by taking a new approach to branding or by considering specialized investment classes such as sustainable investing. But, without buttressing your fees, the only way to save your margin is to clean up the "back of the house". Investment management techniques and products have developed tremendously and there is a growing focus to match this development in the back office.

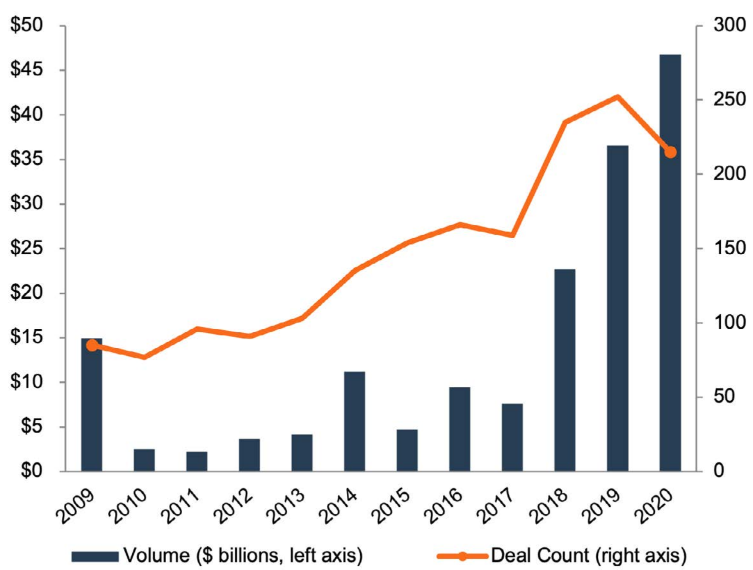
RIA M&A

Deal Activity Rebounds After Brief Lull; Deal Terms and Multiples Remain Robust

After a brief lull during the second quarter of last year, RIA deal activity surged in the fourth quarter, rounding out a record year in terms of reported deal volume. Concerns about the pandemic and market conditions were quickly shrugged off, as deal terms and the pace of deal activity returned to 2019 levels after the brief pause at the peak of the shutdown.

The strong fourth quarter deal activity reflects a continuation of the upward trajectory seen over the last several years. Fourth quarter deal activity was further accelerated by the backlog of deals that had stalled earlier in the year and by the expectation for increases to capital gains tax rates when the new administration takes over. The total reported deal volume in 2020 increased 28% from 2019 levels, and while deal count declined 15% from 2019 levels, the decline was almost entirely attributable to the brief slowdown in the second and third quarters. The average deal count in the first and fourth quarters exceeded the 2019 quarterly average.

Asset/Wealth Manager M&A (2009 - 2020)



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

Deal Terms Remain Robust

Deal terms and multiples for wealth management franchises showed remarkable resilience in 2020. While the height of the market downturn caused some buyers to exercise caution regarding multiples and deal terms, the effect was short-lived. As equity markets rebounded and the uncertainty diminished, deal terms and multiples quickly returned to 2019 levels, with attractive RIA sellers seeing high single digit multiples of EBITDA and meaningful portions of the purchase price paid in cash at closing.

The strength of deal terms is not surprising given the influx of new buyers in recent years. RIA aggregators, strategic acquirors, banks, and private equity have all been elbowing their way to the table, which suggests a continued seller's market.

Consolidators Drive Deal Activity

RIA consolidators and larger RIA strategic acquirers continued to be a driving force behind deal activity. Wealth Enhancement Group, Focus Financial, Hightower, Creative Planning and CI Financial each acquired multiple RIAs in 2020. These firms sustained deal activity during the peak of the pandemic distraction, while smaller acquirors without dedicated deal teams were forced to delay or abandon planned transactions. Consolidators and large strategic acquirors remain an attractive option for many RIA sellers, in part due to the lower execution risk resulting from consolidators' experience in closing transactions.

Mega-Deals

While consolidators accounted for a large percentage of deal activity, these deals are typically relatively small. The uptick in total deal value during the year was driven by several mega-deals among publicly traded asset managers and discount brokerages. Back in February, Franklin Templeton agreed to buy rival asset manager Legg Mason for $6.5 billion, and Morgan Stanley purchased online broker E-Trade for $13 billion just a few days later. In October, Morgan Stanley agreed to buy asset manager Eaton Vance for $7 billion. In December, Macquarie Group (a diversified Australian financial services company) agreed to buy asset and wealth manager Waddell & Reed for $1.7 billion.

The differences between these larger transactions and the smaller wealth management firm transactions are noteworthy. The recent mega-deals in the industry between public companies have been focused on sectors of the industry that many analysts believe are in decline—asset management and discount brokerage. These sectors have seen significant fee and margin compression in recent years, and as a result these deals are largely defensive in nature and motivated by cost savings and increasing scale to protect margins.

In contrast, buyers of independent wealth management firms are typically attracted by recurring revenue, a sticky client base, relatively high margins, and attractive growth prospects due to market appreciation and demographic trends. As a result of these differing motivations and outlooks, the multiples seen for wealth management franchises are often higher than their publicly traded asset management-focused counterparts. In the case of the Waddell & Reed transaction, the multiple paid for the asset management component of the business may have been as low as 5x, well below what an attractive wealth management business can expect in the current environment.

Internal Transactions

Many of our RIA clients have taken time over the last year to work on back-of-house issues like succession planning. It's no secret that succession planning is a major issue for the industry, and one of the questions RIA principals must answer when succession planning is whether to engage in an internal or external transaction. Although there has been a proliferation of external buyers and deal terms remain strong, internal transactions can be an attractive option for a variety of reasons. Compared to the stringent structure that an outside buyer might impose, internal transactions can offer greater flexibility for retiring partners. They also sidestep one of the largest issues in RIA transactions—cultural compatibility—since no new parties are introduced and forced to work together.

One of the downsides of internal transactions is that the buyers, typically younger firm employees, often don't have the financial resources to purchase a significant interest outright. The good news is that capital options to facilitate these transactions have expanded significantly in recent years, with various banks, private equity, and minority investors increasing their focus on the sector.

Another challenge with internal transactions is that they require a strong next-gen management team to be in place. Without a strong bench, external transactions may be the only option for a founding partner seeking to exit the business. For firms that lack the next-gen management to run the business and turn to external buyers to solve their succession planning problem, it may be difficult to realize full value.

Investment Manager Multiples by Sector

				Pricing as of December 31, 2020			
	Ticker	12/31/2020 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	149.27	92.1%	13.3x	nm	1.64	7.0x
GAMCO Investors, Inc.	GBL	17.74	90.4%	6.4x	nm	1.68	5.2x
Hennessy Advisors, Inc,	HNNA	8.52	76.4%	8.0x	nm	1.49	4.4x
Pzena Investment Management, Inc.	PZN	7.30	82.9%	nm	nm	1.63	18.9x
Silvercrest Asset Management Group	SAMG	13.89	94.1%	12.0x	10.5x	1.00	7.1x
Westwood Holdings Group, Inc.	WHG	14.50	48.3%	nm	nm	0.95	nm
Waddell & Reed Financial, Inc.	WDR	25.47	98.3%	16.2x	15.9x	2.35	10.2x
Virtus Investment Partners, Inc.	VRTS	217.00	99.3%	18.9x	13.6x	1.48	6.3x
Group Median			**91.3%**	**12.6x**	**13.6x**	**1.56**	**7.0x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $100B)							
AllianceBerstein Investments, Inc.	AB	33.77	93.6%	12.2x	12.5x	1.46	7.4x
BlackRock, Inc.	BLK	721.54	99.9%	24.5x	22.5x	1.46	17.3x
Eaton Vance Corp.	EV	67.93	98.2%	24.2x	20.4x	1.88	21.7x
Federated Investors, Inc.	FHI	28.89	75.5%	9.4x	9.6x	0.48	6.7x
Franklin Resources, Inc.	BEN	24.99	90.5%	11.2x	9.2x	1.12	11.5x
Invesco Ltd.	IVZ	17.43	91.7%	9.2x	10.0x	1.36	12.7x
T. Rowe Price Group, Inc.	TROW	151.39	98.1%	17.0x	16.6x	2.56	12.1x
Group Median			**93.6%**	**12.2x**	**12.5x**	**1.46**	**12.1x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	APO	48.98	88.4%	nm	27.2x	5.50	nm
Ares Management Corp	ARES	47.05	94.4%	20.7x	26.7x	10.17	nm
Associated Capital Group Inc	AC	35.12	53.7%	nm	nm	77.76	nm
Blackstone Group Inc/The	BX	64.81	98.6%	57.1x	27.9x	9.43	77.9x
Carlyle Group LP/The	CG	31.44	89.9%	nm	17.4x	5.50	nm
Cohen & Steers Inc	CNS	74.30	94.3%	29.7x	30.0x	5.02	22.6x
Hamilton Lane Inc	HLNE	78.05	92.3%	40.4x	41.2x	10.68	30.2x
KKR & Co Inc	KKR	40.49	99.5%	nm	23.9x	31.49	nm
Sculptor Capital Management Inc	SCU	15.20	52.7%	nm	10.6x	4.41	nm
Group Median			**92.3%**	**35.1x**	**27.0x**	**9.43**	**30.2x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	101.70	98.4%	44.0x	8.0x	1.29	11.0x
Artisan Partners Asset Management Inc.	APAM	50.34	99.0%	18.3x	15.6x	3.04	12.4x
Focus Financial Partners Inc	FOCS	43.50	92.2%	25.3x	14.8x	na	16.4x
Victory Capital Holdings Inc	VCTR	24.81	99.4%	8.0x	6.6x	1.84	7.6x
BrightSphere Investment Group	BSIG	19.28	97.5%	7.8x	11.3x	1.17	8.2x
Group Median			**98.7%**	**21.8x**	**11.4x**	**1.84**	**11.67**
OVERALL MEDIAN			**93.0%**	**17.0x**	**15.8x**	**1.84**	**11.5x**

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

Sectors Served

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

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