MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

VALUE FOCUS

Investment Management

Third Quarter 2021 | Segment Focus: Alternative Asset Managers

In This Issue

In this issue, we review public market performance across the investment management industry amidst the recent stock market pull back. While AUM balances for many firms remain near all-time highs, investor sentiment appears less optimistic as long-time industry headwinds return to focus and smaller publicly traded investment advisors underperform relative to both their larger peers and the S&P 500.

In our segment focus for this quarter, we focus on the performance of alternative asset managers, which have generally outperformed other categories of RIAs over the last year following several years of relative underperformance. This rebound is largely due to heightened volatility and renewed demand for alternative assets amidst growing investor appetite for risk.

In our RIA M&A update, we address industry M&A trends and factors driving record deal activity. Deal volume continues to be supported by secular trends, favorable capital markets, and fears of impending tax code changes. As competition for deals reaches new highs, RIA Consolidators with private equity backing are increasingly crowding out traditional RIA-to-RIA transactions and shaping investor demand across the RIA industry.

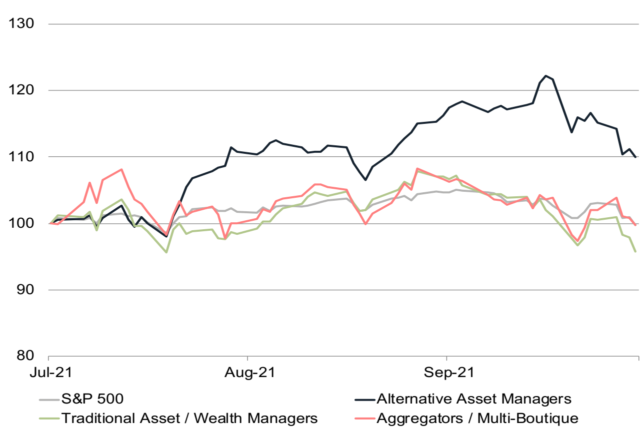
RIA Market Update

RIA stocks saw mixed performance during the third quarter amidst volatile performance in the broader market. In September, the S&P 500 had its worst month since March 2020, and many publicly traded asset and wealth management stocks followed suit.

Performance varied by sector, with alternative asset managers faring particularly well over the last quarter. Our index of alternative asset managers was up 10% during the quarter, reflecting bullish investor sentiment for these companies based in part on long-term secular tailwinds resulting from rising asset allocations to alternative assets.

The index of traditional asset and wealth managers declined 4% during the quarter, with performance reflecting the pullback in the broader market. RIA aggregators experienced a volatile quarter, but ended flat relative to the prior quarter end. The performance of RIA aggregators may be reflective of mixed investor sentiment towards the aggregator model. While the opportunity for consolidation in the RIA space is significant, investors in aggregator models have expressed mounting concern about rising competition for deals and high leverage at many aggregators which may limit the ability of these firms to continue to source attractive deals.

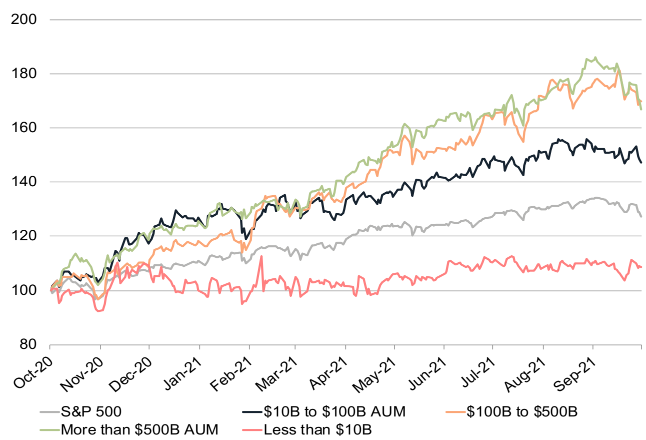
Investment Management Performance by Sector: Q3 2021



Source: S&P Global Market Intelligence

Performance for many of these public companies continued to be impacted by headwinds including fee pressure, asset outflows, and the rising popularity of passive investment products. These trends have especially impacted smaller publicly traded asset managers, while larger scaled asset managers have generally fared better. For the largest players in the industry, increasing scale and cost efficiencies have allowed these companies to offset the negative impact of declining fees. Market performance over the last year has generally been better for larger firms, with firms managing more than $100B in assets outperforming their smaller counterparts.

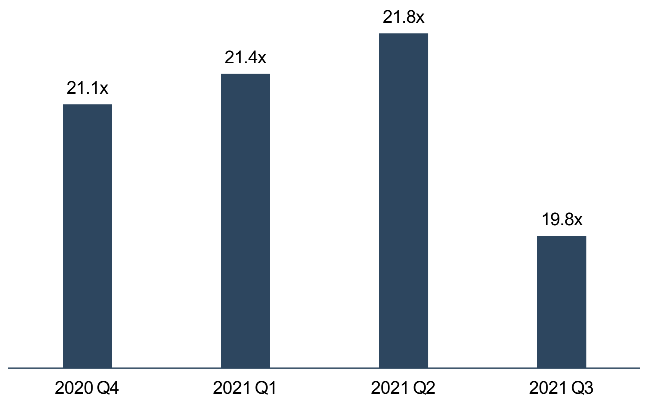
Investment Management Performance by AUM Size: LTM Ended 09/30/21



Source: S&P Global Market Intelligence

As valuation analysts, we're often interested in how earnings multiples have evolved over time, since these multiples can reflect market sentiment for the asset class. After steadily increasing over the second half of 2020 and first half of 2021, multiples pulled back moderately during the most recent quarter, reflecting the market's anticipation of lower or flat revenue and earnings as the market pulled back and AUM declined.

Price to LTM EPS for Traditional Asset / Wealth Managers



Source: S&P Global Market Intelligence

Implications for Your RIA

The value of public asset and wealth managers provides some perspective on investor sentiment towards the asset class, but strict comparisons with privately-held RIAs should be made with caution. Many of the smaller publics are focused on active asset management, which has been particularly vulnerable to the headwinds such as fee pressure and asset outflows to passive products. 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.

The market for privately held RIAs has remained strong as investors have flocked to the recurring revenue, sticky client base, low capex needs, and high margins that these businesses offer. Deal activity continues to be significant, and multiples for privately held RIAs remain at or near all time highs due to buyer competition and shortage of firms on the market.

Improving Outlook

The outlook for RIAs depends on several 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.

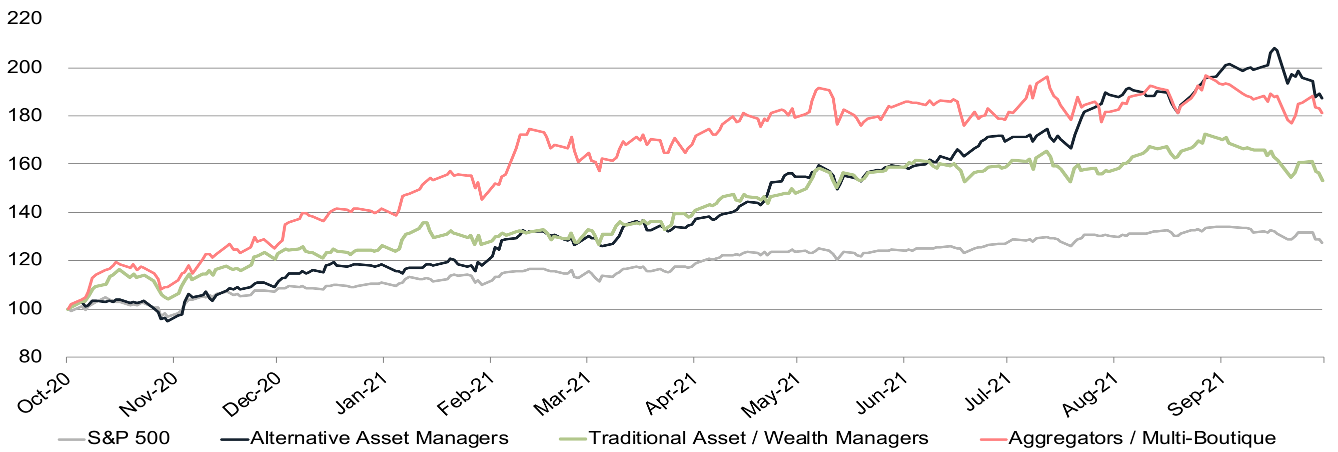
The impact of market movements varies by sector, however. Alternative asset managers tend to be more idiosyncratic but are still influenced by investor sentiment regarding their hard-to-value assets. Wealth manager valuations are somewhat tied to the demand from consolidators while traditional asset 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 remained strong despite volatility over the prior quarter. AUM remains at or near all-time highs for many firms, and it's likely that industry-wide revenue and earnings are as well. Given this backdrop, many RIAs are well positioned for strong financial performance in the fourth quarter.

Segment Focus: Alternative Asset Managers

Public Alt Asset Managers Have Nearly Doubled in Value Over the Last Year

Investment Manager Performance by Sector: LTM Ended 09/30/21



Source: Mercer Capital (Pricing data from SNL Financial)

Industry Overview and History

Over the last year, alternative asset managers have bested the market and most other categories of investment management firms by a considerable margin. Favorable market conditions, heightened volatility, strong investment returns, and growing interest from institutional investors are the primary drivers behind the sector's recent rally. Our alt manager index actually doubled from October of 2020 to August of this year before giving back some of these gains during the market downturn last month.

Before this uptick, many alternative asset managers had struggled over the last several years. Asset outflows, the rising popularity of passive products, fee pressure, and underperformance relative to broader market returns had caused many hedge funds and PE firms to lag other investment management sectors. Industry valuations appear to have bottomed out with the market collapse during the first quarter of last year and have since rebounded. Growing investor appetite for risky assets with purported diversification benefits has fueled a fairly substantial turnaround for the sector over the last eighteen months or so. Current pricing is close to the 52-week high, and forward multiples are noticeably lower than LTM multiples, suggesting peaked valuations and expected earnings increases over the next twelve months.

While hedge funds have underperformed since the Financial Crisis (the S&P 500 index has dwarfed the performance of hedge funds as measured by the HFRI Fund Weighted Composite Index since 2009), recent volatility has improved their performance on a relative basis. Hedge fund capital typically lags its underlying fund performance, so the market seems to be anticipating that higher inflows in the coming months as investors reallocate their portfolios in light of recent performance.

Alternative assets often 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 of years, pension funds have started diversifying their portfolios to include alternative investments in order to chase higher risk, higher return assets. It is more difficult for the average investor to gain exposure to alternative assets due to 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 the pandemic and a slowing IPO market. While investor interest in uncorrelated asset classes such as alternatives fell during the longest bull market run in history (2009-20), recent volatility has pushed investors back to the asset class.

Franklin Resources's (ticker: BEN) recently announced purchase of private equity firm Lexington Partners for $1.75 billion is illustrative of growing interest from more traditional asset managers in the alt space.

Practice Management

Today, the main priority for most alternative asset managers is raising assets. Assets follow performance and fee reduction, especially in the alternatives space, are the most consequential ways to attract fund flow. After a decade of lackluster performance, alternative managers have had no choice but to look to price reduction 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. 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.

Summary

Despite improving performance over the last year or so, the alt asset sector continues to face many 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 the goal of imitating private equity returns. Innovative products are being introduced 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.

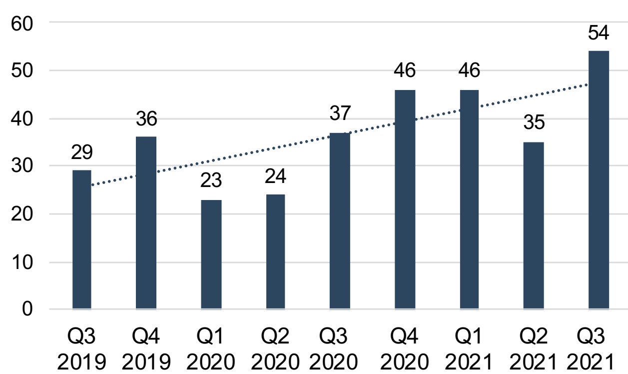
RIA M&A

Are Consolidators Crowding Out Traditional RIA-to-RIA Acquisitions?

Despite the dip in the second quarter of 2021, RIA M&A activity continues to reach record highs putting the sector on track for its ninth consecutive year of record annual deal volume.

The same three demand drivers **discussed last quarter** persisted throughout the third quarter of 2021: (1) secular trends, (2) supportive capital markets, and (3) looming potential changes in the tax code. While fee pressure in the asset management space and a lack of succession planning by many wealth managers continues to drive consolidation, looming proposals to increase the capital gains tax rate has accelerated some M&A activity in the short-term as sellers seek to realize gains at current rates. Increased funding availability in the space has further propelled deal activity as acquisitions by consolidators and direct private equity investments increased significantly as a percentage of total deals during the recent quarter.

Deal Volume



Source: Fidelity

Private Equity Drives RIA M&A

We've written extensively on the prominence of acquisitions by private equity backed consolidators in the **RIA industry**. Over a decade of rapid growth and persistent profitability has established a class of RIAs with institutional scale as well as an influx of new entrants. According to a recent study by **McKinsey**, in 2020 there were 15 retail-oriented RIAs eclipsing $20 billion in AUM while approximately 700 new RIAs were started annually over the past five years. This dynamic of a handful of large, financially mature firms surrounded by a highly fragmented market has attracted immense buying activity from private equity sponsors looking to leverage the number of established firms with expertise and scale available to acquire lower valuation, high growth RIA firms in the earlier stages of development.

Three-quarters of Barron's 2020 top 20 RIAs are owned by private equity firms or other financial institutions. Notable examples such as Focus Financial (backed by Stone Point Capital prior to IPO), HighTower Advisors (Thomas H. Lee Partners), Wealth Enhancement Group (TA Associates), and Mercer Advisors (Oak Hill Capital Partners) accounted for an outsized share of total deal volume during the third quarter of 2021, and the percentage of total acquisitions made by consolidators increased from 50% to over 70% of all transactions in the past quarter. Direct investments in the third quarter also reached an all-time high for a total of 12 transactions. Such interest from private equity backed buyers continues to support high valuation multiples.

2021 RIA-to-RIA transactions as a percentage of total deal volume is expected to be at a ten-year low largely due to the increase in acquisitions made by consolidators and private equity direct investments. Increased competition for deals favors consolidators who have dedicated deal teams, capital backing, and experience to win larger transactions, and even multiple large transactions simultaneously. The trend is evidenced by increased AUM size per deal, which is on track to reach a record high for the fourth consecutive year. While this is partially a result of increased AUM due to strong market performance, Echelon Partners notes that the persistent increase is also likely due to the deep pocketed supply of capital by sophisticated buyers which has caused demand for acquisitions to outpace the supply of firms looking to sell.

While systemic factors continue to be a primary driver of RIA deal activity, the surge in acquisitions made by financial buyers has led some to question the sustainability of recent M&A highs. Notably, while deal volume increased to record levels in September 2021, investor sentiment for RIA consolidators was mixed during the same period as investors have expressed concern about rising competition for deals and high leverage which may limit the ability of these firms to continue to source attractive deals in the future. Private equity buyers, and consolidators acting as private equity portfolio companies, are motivated by investment opportunity. As financial buyers flock to opportunities, they drive up valuations and simultaneously diminish IRR. Recent private equity and consolidator interest in the UK market exemplifies the saturated valuations in the U.S. market as buyers have begun to seek out cheaper entry points abroad.

While deal volume has continued to reach new highs for nearly a decade now, there continues to be ample supply of potential acquisition targets (although not all of these firms are actively looking to sell today). The RIA industry remains highly fragmented and growing with over 13,000 registered firms and more money managers and advisors who are capable of setting up independent shops. Systemic trends and strong buyer demand will likely continue to bring sellers to market, and for now, there are no signs that momentum in deal activity is stalling anytime soon.

What Does This Mean for Your RIA Firm?

- **If you are planning to grow through strategic acquisitions,** the price may be higher, and the deal terms will likely favor the seller, leaving you more exposed to underperformance. That said, a long-term investment horizon is the greatest hedge against valuation risks. As discussed in our recent post, RIAs continue to be the ultimate growth and yield strategy for strategic buyers looking to grow their practice or investors capable of long-term holding periods. RIAs will likely continue to benefit from higher profitability and growth compared to broker-dealer counterparts and other diversified financial institutions.
- **If you are considering an internal transition,** there are many financing options to consider for buy outs. A seller-financed note has traditionally been one of the primary ways to transition ownership to the next generation of owners (and in some instances may still be the best option), but bank financing can provide the selling partners with more immediate liquidity and potentially offer the next-gen cheaper financing costs.
- **If you are an RIA considering selling,** valuations stand at or near historic highs with ample demand from buyers. That said, it is important to have a clear vision of your firm, its value, and what kind of partner you want before you go to market. A strategic buyer will likely be interested in acquiring a controlling position in your firm with some form of contingent consideration to incentivize the selling owners to transition the business smoothly after closing. Alternatively, a sale to a patient capital provider can allow your firm to retain its independence and continue operating with minimal outside interference. Sellers looking to leverage the scale and expertise of a strategic partner after the transaction may have many buyers to choose from.

For more information, please contact one of our professionals.

Investment Manager Multiples by Sector

	Ticker	9/30/2021 Stock Price	% of 52 Week High	Pricing as of September 30, 2021 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	175.66	95.3%	17.1x	nm	1.52	6.1x
GAMCO Investors, Inc.	GBL	26.38	92.6%	9.8x	nm	1.90	6.0x
Hennessy Advisors, Inc,	HNNA	9.62	80.4%	9.6x	nm	1.66	4.7x
Pzena Investment Management, Inc.	PZN	9.84	81.3%	17.6x	nm	1.44	8.0x
Silvercrest Asset Management Group	SAMG	15.58	90.0%	9.3x	9.3x	1.09	8.0x
Westwood Holdings Group, Inc.	WHG	19.00	77.9%	157.7x	nm	1.03	nm
Group Median			**85.7%**	**13.5x**	**9.3x**	**1.48**	**6.1x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $100B)							
AllianceBerstein Investments, Inc.	AB	49.58	94.2%	14.6x	13.9x	1.84	3.9x
BlackRock, Inc.	BLK	838.66	87.8%	23.1x	22.0x	1.38	15.5x
Federated Investors, Inc.	FHI	32.50	93.5%	11.1x	11.5x	0.52	7.3x
Franklin Resources, Inc.	BEN	29.72	84.2%	8.9x	8.8x	1.28	10.7x
Invesco Ltd.	IVZ	24.11	81.7%	9.5x	8.1x	1.28	9.8x
T. Rowe Price Group, Inc.	TROW	196.70	88.0%	15.5x	15.2x	2.60	11.9x
Virtus Investment Partners, Inc.	VRTS	310.32	93.2%	16.1x	8.6x	1.29	5.7x
Group Median			**88.0%**	**14.6x**	**11.5x**	**1.29**	**9.8x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	APO	61.59	96.4%	7.0x	15.7x	7.12	6.0x
Ares Management Corp	ARES	73.83	91.5%	nm	30.1x	10.18	nm
Associated Capital Group Inc	AC	37.41	91.4%	nm	nm	nm	5.4x
Blackstone Group Inc/The	BX	116.34	85.0%	17.4x	30.8x	22.62	11.0x
Carlyle Group LP/The	CG	47.28	91.8%	6.3x	14.5x	6.56	4.7x
Cohen & Steers Inc	CNS	83.77	93.8%	24.1x	23.0x	4.18	22.4x
Hamilton Lane Inc	HLNE	84.82	88.0%	24.0x	33.4x	0.66	28.4x
KKR & Co Inc	KKR	60.88	90.0%	6.8x	16.8x	26.56	nm
Sculptor Capital Management Inc	SCU	27.89	96.5%	5.1x	6.8x	6.06	5.1x
Group Median			**91.5%**	**7.0x**	**19.9x**	**6.84**	**6.0x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	151.09	83.5%	15.1x	8.8x	1.20	10.6x
Artisan Partners Asset Management Inc.	APAM	48.92	88.0%	11.2x	9.6x	2.25	8.0x
Focus Financial Partners Inc	FOCS	52.37	92.6%	22.6x	13.6x	na	19.1x
Victory Capital Holdings Inc	VCTR	35.01	97.4%	8.9x	7.4x	na	8.3x
Brightsphere Investment Group Inc	BSIG	26.13	94.4%	6.6x	18.7x	0.94	7.2x
Group Median			**92.6%**	**11.2x**	**9.6x**	**1.20**	**8.3x**
OVERALL MEDIAN			**91.4%**	**11.2x**	**13.9x**	**1.59**	**8.0x**

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

Sectors Served

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- Money Managers
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- Investment Consultants
- Hedge Fund Managers
- Real Estate Investment Companies
- Private Equity & Venture Capital Firms
- Bank Trust Departments
- Broker-Dealers / Hybrid RIAs

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

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