MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

VALUE FOCUS

Investment Management

Second Quarter 2022 | Segment Focus: Independent Trust Companies

In This Issue

In our second quarter segment focus, we discuss the state of the RIA industry and the continued tumult shaping the outlook and investor sentiment for RIAs.

Additionally, we cover recent M&A trends for asset and wealth management firms and the factors driving the continued momentum in deal activity during the second quarter.

Also in this issue, we review the impact of demographic, market, and regulatory trends on independent trust companies.

Segment Focus: Independent Trust Companies

Is the Best Wealth Management Platform Really an Independent Trust Company?

The most frequently ignored topic in the wealth management industry may be its first cousin, the independent trust industry. While many still associate trust work with banks, and banks still represent more than three-quarters of the trust industry, the growing prominence of independent trust companies is causing many participants in the investment management space to take another look. In some regards, independent trustcos look a lot like wealth managers, only more evolved.

Fees

Since the credit crisis, there has been a broad-based decline in pricing power across the investment management industry. Assets have poured into low-fee passive products, driving down effective realized fees for asset managers. Wealth managers have been more resilient, but client fee awareness and the threat of robo-advisors remains. Virtually all discount brokerages have been forced to cut trading fees to zero. At the macro level, the trend has been clear: assets across the financial services industry are gravitating towards lower-fee products.

Despite the pricing pressure in the broader industry, trust companies have fared remarkably well. Unlike with asset management, efforts to commoditize or automate trust administration services have yet to gain significant traction. Relative to other segments of the investment management industry, economies of scale for trust administration have proven more difficult to come by. The continued reliance on highly specialized labor has supported robust pricing power for trust services. For many of our independent trust company clients, realized fees have remained steady or even increased over the last five years, while assets under administration have grown through market growth and net inflows.

Market Correlation

The 2022 bear market is having a significant negative impact on the top line for trust companies, as it will for all investment managers that charge a percentage of assets under management. As of the date of this newsletter, equity prices are down around 20% year-to-date.

Normally, trust companies would be shielded from some of the market volatility because of a higher exposure to fixed income. However, the change in the term structure of interest rates this year means bonds are also well off their prices from a few months ago. Consequently, trust company revenue will take a big hit. The effect on trust company profitability will depend on the length and severity of the economic slowdown caused by the market dynamics and the potential of a looming recession.

Unlike many asset and wealth management firms, trust companies often have revenue sources that aren't based on AUM (e.g., tax planning, estate administration fees) which should provide some protection during a market downturn. This, combined with a resilient fee structure, should help trust companies weather the economic climate.

Favorable Demographics

As America becomes older and wealthier, the number of potential clients for the trust industry is poised to grow markedly.

Trust companies primarily service high net worth and ultra-high net worth clients, and both demographics are growing in number. Credit Suisse's Global Wealth Report estimates that about 7% of Americans are millionaires, numbering over 24 million people in 2021.. This is more than double the number a decade ago, and represents more than a 20% increase over the prior two years. At the same time, the median age in the U.S. has increased by 1.5 years in the past decade, and the oldest members of the baby boomer generation are now in their mid-70s.

The average age of millionaires in the U.S. is 62, and over a third of U.S. millionaires are over the age of 65. Consequently, there is a growing pool of clients in need of the kinds of services that the trust industry provides, and that points to a sustained period of organic growth for the industry. While this will also provide a tailwind for wealth management firms – who often start working for clients around the time they retire – it is a more certain opportunity for trust providers, especially to the extent that wealth transfer services are part of a client's equation.

Regulatory Trends

As trust law has developed, a handful of states have emerged as being particularly favorable for establishing trusts. While the trust law environment varies from state to state, leading states typically have favorable laws with respect to asset protection, taxes, trust decanting, and general flexibility in establishing and managing trusts. Opinions vary, but the following states (listed alphabetically) are often identified as states with a favorable mix of these features.

- Alaska
- Delaware
- Florida
- Nevada
- South Dakota
- Tennessee
- Texas
- Washington
- Wyoming

Over the last several decades, many states such as Delaware, Nevada, and South Dakota have modernized their trust laws to allow for perpetual trusts, directed trustee models, and self-settled spendthrift trusts (or asset protection trusts). The directed trust model in particular is a major change in the way trust companies manage assets, and it has been gaining popularity among trust companies and their clients. Under the directed trust model, the creator of the trust can delegate different functions to different parties. Most frequently, this involves directing investment management to an investment advisor other than the trust company (this could be a legacy advisor or any party the client chooses). The administrative decisions and choices related to how the trust's assets are used to enrich the beneficiary are typically charged to the trust company.

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, who 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.

Succession

In our experience, the ownership profile at independent trust companies is often similar to that which we see at wealth management firms, and ownership succession is often a topic of conversation. Ownership issues can include concentration at the founder level, or large stakes held by outsiders who helped capitalized the firm's startup. As with most investment management businesses, independent trust companies tend to be owner-operator businesses, so finding ways to include younger partners and key staff in equity participation is sometimes a challenge.

As we've written about in articles, blogposts, and whitepapers on buy-sell agreements, the dynamic of a multi-generational, arms-length ownership base can be an opportunity for ensuring the long-term continuity of the firm, but it also risks becoming a costly distraction. As the trust industry ages, we see transition planning as potentially being either a competitive advantage (if done well) or a competitive disadvantage (if ignored).

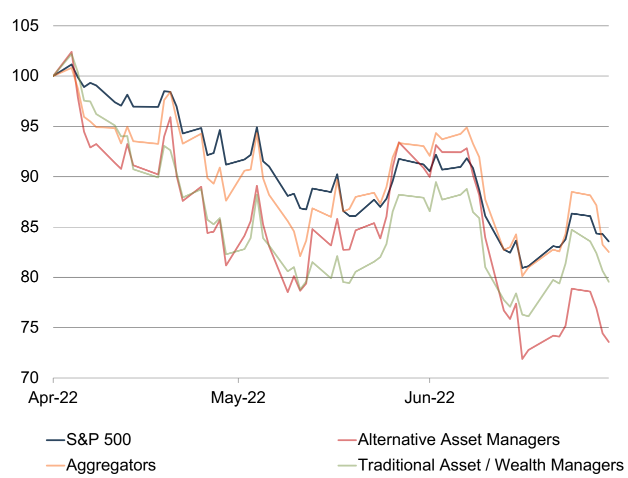
Outlook

Many independent trust companies performed remarkably well over the past decade, and much better than expected during the pandemic. The current bear market is an immediate headwind, but demographic trends in the U.S. and the increased visibility of independent firms as an alternative to bank trust departments should form a solid basis of growth for the foreseeable future.

Industry Trends: Another Tumultuous Quarter for RIA Stocks Puts the Industry Firmly in Bear Market Territory

The RIA industry extended its losing streak last quarter with all classes underperforming the S&P, which also continued its decline.

Investment Manager Performance by Sector
Q2 2022

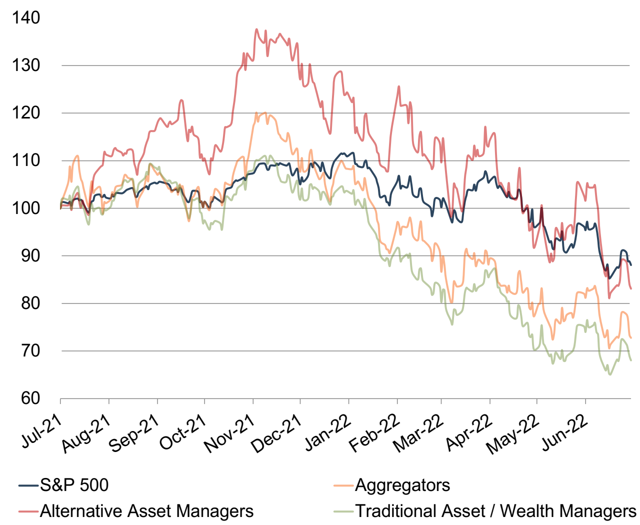


Source: S&P Global Market Intelligence

The market itself is part of the problem as this industry is mostly invested in stocks and bonds, which are down considerably over the last six months. The additional underperformance for asset and wealth managers is likely attributable to lower industry margins as AUM and revenue falls with the market while **labor costs continue to rise**. The impact of **rising interest rates** has exacerbated this decline for alternative asset managers and RIA aggregators, which frequently employ leverage to make investments.

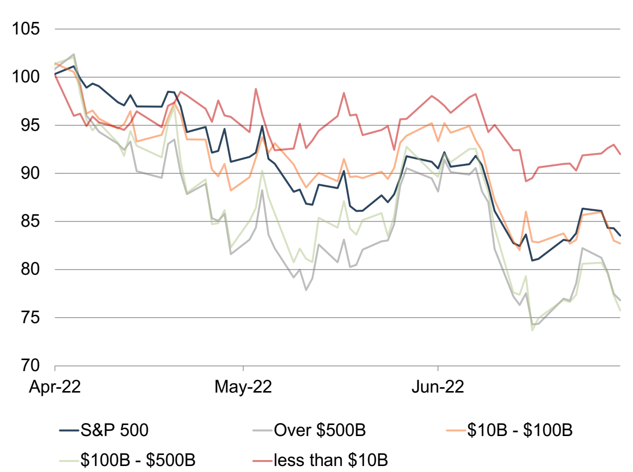
The one bright spot for the industry is the group of smaller (under $10 billion in AUM) publicly traded RIAs, which is the only segment to outperform the market last quarter. This group is still down over the last three months but is holding up relatively well due to the lack of aggregator firms in its composition.

Investment Manager Performance by Sector
Year ended June 30, 2022



Source: S&P Global Market Intelligence

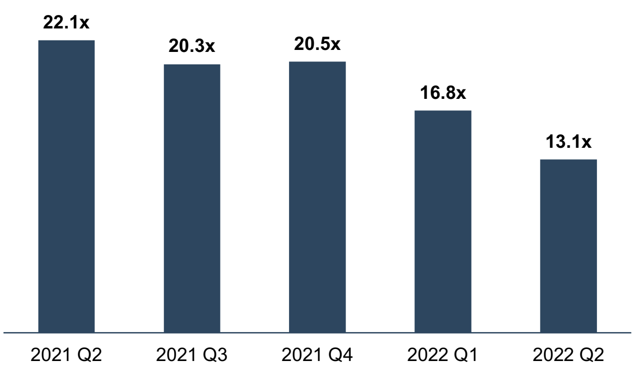
Investment Manager Performance by AUM Size
Q2 2022



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 quarter of 2021, LTM earnings multiples for publicly traded asset and wealth managers declined modestly in the back half of last year before dropping nearly 40% so far this year, reflecting investor anticipation of lower revenue and earnings from the recent market decline.

Price to LTM EPS for Traditional Asset / Wealth Managers



Source: S&P 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 closely 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.

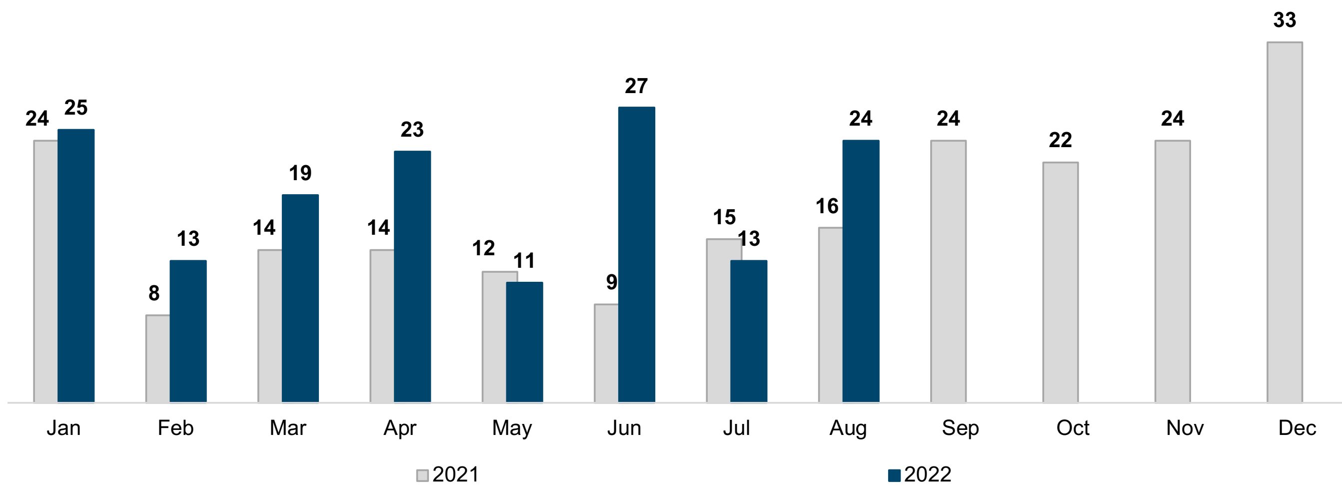
In contrast to public asset/wealth managers, many smaller, private RIAs, particularly those focused on wealth management for HNW and UHNW individuals, have been more insulated from industry headwinds, and the fee structures, asset flows, and deal activity for these companies have reflected this.

Notably, the market for privately held RIAs remained strong in 2021 as investors flocked to the recurring revenue, sticky client base, low capex needs, and high margins that these businesses offer. Deal activity for these businesses continued to be significant in 2021, and multiples for privately held RIAs tested new highs due to buyer competition and shortage of firms on the market. A continuation of these dynamics into 2022 is likely to provide some support for valuation multiples and deal activity despite a backdrop of rising interest rates and deteriorating market conditions.

RIA M&A

Second Quarter 2022

Number of RIA M&A Transactions, 2021 vs 2022 YTD



Source: Fidelity

Year-to-date RIA M&A activity has surpassed last year's record levels so far in 2022 even as macro headwinds for the industry continue to mount. Fidelity's May 2022 Wealth Management M&A Transaction Report listed 93 deals through May of 2022, up from 72 during the same period in 2021. These transactions represented $135 billion in AUM, up 12% from 2021 levels.

The continued strength of RIA M&A activity amidst the current environment dominated by inflation, rising interest rates, and a tight labor market is noteworthy given that all of these factors could put a strain on the supply and demand dynamics that have driven deal activity in recent years. Rising costs and interest rates coupled with a declining fee base will put pressure on highly-leveraged consolidator models, and a potential downturn in performance could put some sellers on the sidelines until fundamentals improve.

But despite these pressures, the market has proven robust (at least so far). Demand for RIAs has remained strong, with professionalization of the buyer market continuing to be a theme driving M&A activity. Deal volume is increasingly driven by serial acquirers and aggregators with dedicated deal teams and access to capital. Mariner, CAPTRUST, Beacon Pointe, Mercer Advisors, Creative Planning, Wealth Enhancement Group, Focus Financial, and CI Financial all completed multiple deals during the first five months of the year.

This group of companies, along with other strategic acquirers and consolidators, have continued to increase their share of industry deal volume and now account for about half of all deals. In addition to driving overall industry deal volume, the proliferation of strategic acquiror and aggregator models has led to increased competition for deals throughout the industry, which has contributed to multiple expansion and shifts to more favorable deal terms for sellers in recent years. While there are some signs that deal activity from these acquirors may slow down (CI Financial's CEO Kurt McAlpine remarked on the company's first quarter earnings call that their pace of acquisitions has "absolutely slowed down"), we've not yet seen that borne out in the reported deal volume.

On the supply side, the motives for sellers often encompass more than purely financial considerations. Sellers are often looking to solve for succession issues, to improve quality of life, and to access organic growths strategies. Such deal rationales are not sensitive to the market environment, and will likely continue to fuel the M&A pipeline even in a downturn. And despite years of record setting M&A activity, the number of RIAs **continues to grow**—which suggests the uptick in M&A activity is far from played out.

Whatever net impact the current market conditions have on RIA M&A, it may take several months before the impact becomes apparent in reported deal volume given the often multi-month lag between deal negotiation, signing, and closing. But at least through May, transaction activity has remained steady or even surpassed last year.

What Does This Mean for Your RIA?

For RIAs Planning to Grow Through Strategic Acquisitions

Pricing for RIAs has continued to trend upwards in recent years, leaving you more exposed to underperformance. While the impact of current macro conditions on RIA deal volume and multiples remains to be fully seen, structural developments in the industry and the proliferation of capital availability and acquiror models will likely continue to support higher multiples than the industry has been accustomed to in the past. That said, a long-term investment horizon is the greatest hedge against valuation risks. Short-term volatility aside, 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.

For RIAs Considering Internal Transactions

We're often engaged to address valuation issues in internal transaction scenarios. Naturally, valuation considerations are front of mind in internal transactions as they are in most transactions. But how the deal is financed is often an important secondary consideration in internal transactions where buyers (usually next-gen management) lack the ability or willingness to purchase a substantial portion of the business outright. As the RIA industry has grown, so too has the number of external capital providers who will finance internal transactions. 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 there are also an increasing number of bank financing and other external capital options that 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

After years of steadily increasing multiples and fundamental performance, RIA valuations are now at or near all-time highs. But whatever the market conditions when you go to sell, 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. As the RIA industry has grown, a wide spectrum of buyer profiles has emerged to accommodate different seller motivations and allow for different levels of autonomy post transaction. A strategic buyer will likely be interested in acquiring a controlling position in your firm and integrating a significant portion of the business to create scale. At the other end of the spectrum, a sale to a patient capital provider can allow your firm to retain its independence and continue operating with minimal outside interference. Given the wide range of buyer models out there, picking the right buyer type to align with your goals and motivations is a critical decision, and one which can have a significant impact on personal and career satisfaction after the transaction closes.

Investment Manager Multiples by Sector

				Pricing as of June 30, 2022			
	Ticker	6/30/2022 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	173.64	82.2%	8.4x	nm	1.71	5.4x
GAMCO Investors, Inc.	GBL	20.90	70.5%	7.2x	nm	1.40	3.9x
Hennessy Advisors, Inc,	HNNA	10.44	92.8%	10.2x	nm	1.62	na
Pzena Investment Management, Inc.	PZN	6.59	58.9%	7.4x	nm	0.39	1.8x
Silvercrest Asset Management Group	SAMG	16.41	73.0%	9.6x	9.6x	N/A	2.2x
Westwood Holdings Group, Inc.	WHG	13.80	58.2%	18.9x	nm	0.74	13.0x
Group Median			**71.8%**	**9.0x**	**9.6x**	**1.40**	**3.9x**
TRADITIONAL ASSET / WEALTH MANAGERS (AUM OVER $100B)							
AllianceBerstein Investments, Inc.	AB	41.58	76.3%	10.3x	13.1x	1.59	3.8x
BlackRock, Inc.	BLK	609.04	63.7%	15.9x	16.4x	1.00	11.0x
Federated Investors, Inc.	FHI	31.79	81.2%	13.3x	11.1x	0.51	8.6x
Franklin Resources, Inc.	BEN	23.31	62.8%	5.6x	6.5x	1.22	7.4x
Invesco Ltd.	IVZ	16.13	61.1%	6.2x	6.7x	1.07	6.9x
T. Rowe Price Group, Inc.	TROW	113.61	52.2%	9.2x	11.4x	1.62	6.4x
Virtus Investment Partners, Inc.	VRTS	171.02	51.5%	5.5x	5.9x	0.76	2.9x
Group Median			**62.8%**	**9.2x**	**11.1x**	**1.07**	**6.9x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management LLC	APO	48.48	61.0%	nm	8.5x	6.33	20.9x
Ares Management Corp	ARES	56.86	64.7%	29.4x	17.7x	7.67	nm
Associated Capital Group Inc	AC	35.83	75.6%	nm	nm	nm	18.4x
Blackstone Group Inc/The	BX	91.23	62.3%	12.2x	15.9x	14.02	7.6x
Carlyle Group LP/The	CG	31.66	53.0%	4.1x	8.0x	4.06	3.3x
Cohen & Steers Inc	CNS	63.59	64.4%	13.4x	16.7x	3.15	11.3x
Hamilton Lane Inc	HLNE	67.18	58.7%	19.5x	15.7x	3.92	21.9x
KKR & Co Inc	KKR	46.29	55.6%	10.0x	10.9x	24.48	nm
Sculptor Capital Management Inc	SCU	8.35	29.5%	35.7x	2.5x	3.71	13.1x
Group Median			**61.0%**	**13.4x**	**13.3x**	**5.20**	**13.1x**
AGGREGATORS							
Affiliated Managers Group, Inc.	AMG	116.60	60.9%	8.9x	6.3x	1.05	8.3x
Artisan Partners Asset Management Inc.	APAM	35.57	73.3%	7.4x	9.9x	na	5.4x
Focus Financial Partners Inc	FOCS	34.06	49.3%	10.1x	7.5x	na	13.8x
Victory Capital Holdings Inc	VCTR	24.10	57.2%	5.5x	5.1x	1.52	6.6x
Brightsphere Investment Group Inc	BSIG	18.01	57.9%	13.3x	9.4x	0.99	5.3x
Group Median			**57.9%**	**8.9x**	**7.5x**	**1.05**	**6.6x**
OVERALL MEDIAN			**61.1%**	**10.0x**	**9.6x**	**1.59**	**7.2x**

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

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

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