VALUE FOCUS

Investment Management

Fourth Quarter 2018 | Segment Focus: Trust Companies

In This Issue

Following a decade of (fairly) steady appreciation, RIA stocks finally capitulated with the market downturn and growing concerns over fee compression and asset flows. As a leading indicator, such a decline suggests the outlook for these businesses has likely soured over the last year or so.

Against a bearish backdrop for the industry as a whole, all three trust bank stocks declined in the last few months of the year with falling client asset balances and rising labor costs. Thus, trust banks are relying on technology to ease some of the pressure from their customers on cost.

Asset manager M&A was robust throughout 2018 despite volatile market conditions. Several trends which have driven the uptick in sector M&A in recent years have continued into 2018, including increasing activity by RIA aggregators and rising cost pressures. Total deal count during 2018 increased 49% versus 2017, and total disclosed deal value was up nearly 140% to $18.0 billion. In terms of both deal volume and deal count, asset manager M&A reached the highest levels since 2009.

Trust Companies

Trust Companies' Performance and the Role of Technology

Trust banks have generally lagged the broader indices since the financial crisis of 2008 and 2009. Against a bearish backdrop for the industry as a whole, all three trust bank stocks declined in the last few months of the year with falling client asset balances and rising labor costs.

Northern Trust and BNY Mellon performed more in line with the market and traditional banks while State Street's underperformance is largely attributable to investor skepticism surrounding its purchase of Charles River Systems last summer.

Customers Demand Improved Technology Offerings

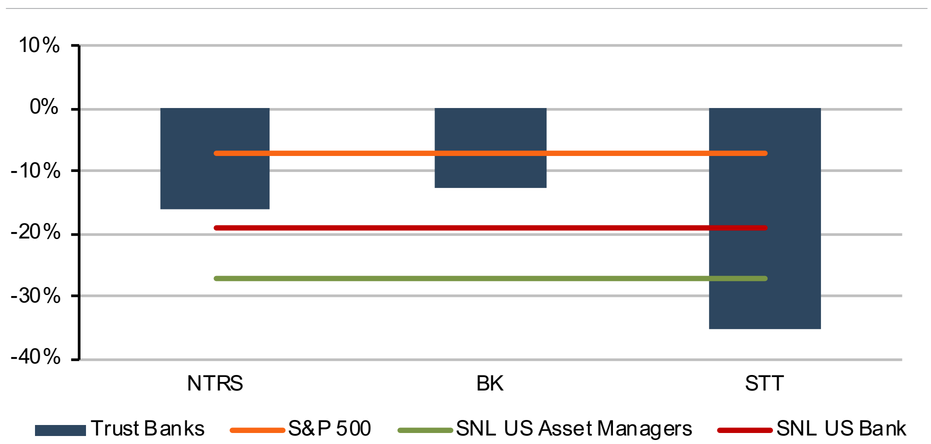
As noted during a **conversation with Jay Hooley and Ron O'Hanley at State Street**, the industry is going through a "time of unprecedented change." Investment firms are devoting more time and resources to keep up with the most recent technological offerings and improve the overall client experience. These dynamics are especially true for trust banks, where increased regulation has encouraged advancement in data management.

IT investment is outlined as a clear priority for success. BNY Mellon invested $2.4 billion in IT last year and plans to spend another $2.7 billion going forward **to develop their operating platform**. Northern Trust **utilizes technology in order to provide momentum** to its growth strategies and cut costs "to take advantage of new technologies such as **robotics to slim down** its permanent workforce."

Another example of trust banks directing resources to technological development is State Street's recent acquisition of Charles River Systems for $2.6 billion. Charles River is a financial data firm that runs a software platform used by more than 300 asset management firms. **According to Ron O'Hanley**, president and CEO of State Street, "This acquisition represents not only a significant investment in our future but also the recognition that the ability to assist clients in managing their data needs and extract insights from their data is increasingly the most important differentiator for our industry."

Investors disagreed as STT's share price declined sharply after the announcement (**pessimism surrounding the acquisition**) as the 38% increase in total assets under custody from the acquisition will not be met with proportional increases in revenue. At the moment, investors are questioning if State Street's focus on data management in addition to asset management will in fact create shareholder value in the long run.

Trust Banks' Total Returns: 2018



Source: S&P Global Market Intelligence

Is Pricing Indicative of Performance in a Down Market?

Trust bank trailing and forward multiples have fallen in line with the broader market.

Trust Companies Pricing Information

	Ticker	12/31/18 Price	% of 52 Week High	Price / Trailing EPS	Price / Fwd EPS
Northern Trust Company	NTRS	$83.59	72.3%	12.7x	12.8x
Bank of New York Mellon Corporation	BK	$47.07	79.8%	11.3x	11.3x
State Street Corporation	STT	$63.07	55.2%	8.7x	8.8x
Group Median			**72.3%**	**11.3x**	**11.3x**

Source: Bloomberg

A quick glance at year-end pricing shows the group valued at 9-13x (forward and trailing, respectively) earnings, down from 14-16x at year-end 2017 as the outlook on future cash flows has stalled with the recent market correction.

Despite trust banks' underperformance during 2018, investment management fees increased year-over-year (as of the third quarter, the most recent information available). Servicing fees varied by company. State Street saw a decline in servicing fees **due to what it explains** as "client transitions and challenging industry conditions." BNY Mellon's fees were relatively flat and Northern Trust saw an increase in servicing fees **partially due to the UBS fund administrator acquisition** which closed in late 2017. As a whole, trust banks saw improved net interest margins due to higher U.S. market interest rates.

Are Investors too Bearish on State Street?

State Street's stock price has been hammered even more than the industry as a whole. State Street's ETF business has historically helped it outperform peers. However, legacy contracts have disabled them from cutting fees in order to remain competitive. State Street has begun restructuring its ETF business, but it will take time to regain its market position. In light of these challenges, **State Street's share of the U.S. ETF industry** was at an all-time low by July 2018. Despite the recent struggles with its ETF business and the market's perception of the Charles River acquisition, State Street ($34 trillion in AUCA) is still on track to surpass BNY Mellon ($34.5 trillion AUCA) as the largest custody bank in terms of assets under custody and administration.

Trust Banks are Bullish on Technology

Trust banks are relying on technology to ease some of the pressure from their customers on cost. More barriers to entry have developed in the industry as regulators have made it harder to obtain approval to operate as a custody bank. This stricter regulation has forced these companies to adopt technological platforms which, if done properly, can provide added value to customers.

Market Overview

RIA Stocks Suffer Worst Quarter Since Financial Crisis

What Goes Up Must Come Down...

Prior to last year, RIA stocks benefited immensely from the bull run that began in March 2009, besting the market by over 60% during this favorable period for asset returns (Chart 1). In 2018, this trend reversed course, and the return of market volatility and negative returns precipitated a broad decline across all industry sectors (Chart 2).

Traditional active managers have felt these pressures most acutely, as poorly differentiated products struggled to withstand downward fee velocity and at the same time have been a prime target of regulatory developments. To combat fee pressure, traditional asset managers have had to either pursue scale (e.g. BlackRock) or offer products that are truly differentiated (something that is difficult to do with scale). Investors have been more receptive to the value proposition of wealth management firms as these businesses are (so far) better positioned to **maintain pricing schedules**.

Chart 1 | RIA Stocks Versus the S&P 500 (3/9/09 to 12/31/17)

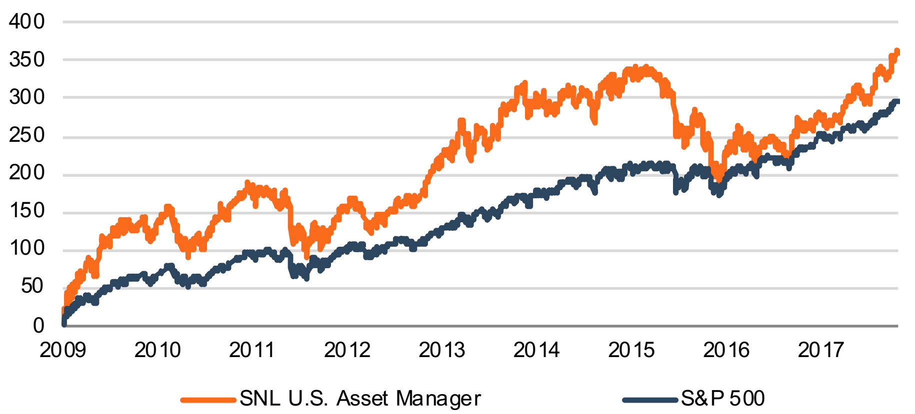
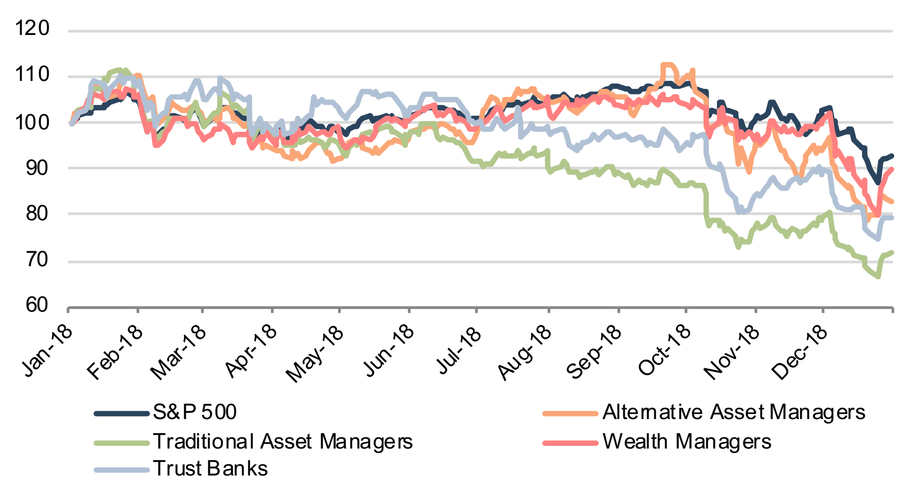


Chart 2 | Asset Manager Performance by Sector - 2018



Source: S&P Global Market Intelligence

Reflective of the headwinds that the industry faces, asset managers generally underperformed broad market indices during the fourth quarter. As the broader indices stumbled, many RIA stocks plummeted with falling AUM balances and management fees. The operating leverage inherent in the business model of most asset managers suggests that market movements tend to have an amplified effect on the profitability (and stock prices) of these businesses as displayed by their performance in the last quarter (Chart 3 on page 4).

Does Size Matter for RIAs?

The corresponding RIA size graph seems to affirm this (Chart 4). The larger firms generally outperformed smaller RIAs though all categories were down in the quarter. Still, this trend is admittedly a bit misleading since the smallest category of publicly traded RIAs (those with less than $10 billion in AUM) was down nearly 30% during the quarter, although this is the least diversified category of RIAs with only two components. Due to the lack of diversification, this category is subject to a high degree of volatility due to company-specific developments. Most of our clients are in this size category, and we believe it is highly unlikely that these businesses lost almost a third of their value (in aggregate) over the quarter.

Generally speaking, larger RIAs typically attract higher valuations due to the benefits of scale and a more diverse AUM base. Still, capacity constraints can be an issue, particularly for niche and small cap investment products. So, unless you're BlackRock, there's probably a sweet spot for optimal asset size.

A (More) Bearish Outlook

The outlook for these businesses is market driven – though it does vary by sector. Trust banks are more susceptible to changes in interest rates and yield curve positioning. Alternative asset managers tend to be more idiosyncratic but still influenced by investor sentiment regarding their hard-to-value assets. Wealth managers and traditional asset managers are more vulnerable to trends in active and passive investing.

On balance, the outlook for 2019 doesn't look great given what happened to RIA stocks last quarter. The market is clearly anticipating lower AUM, revenue, and earnings with the recent correction, which could be exacerbated by asset outflows if clients start withdrawing their investments. Markets have bounced back a bit so far in 2019, which could be a silver lining for RIA stocks, although volatility remains high. More attractive valuations could also entice more M&A, which is still relatively subdued despite the recent uptick in deal-making. We'll keep an eye on all of it in what will likely be a very interesting year for RIA valuations.

Chart 3 | Investment Management Performance by Sector: Q4 2018

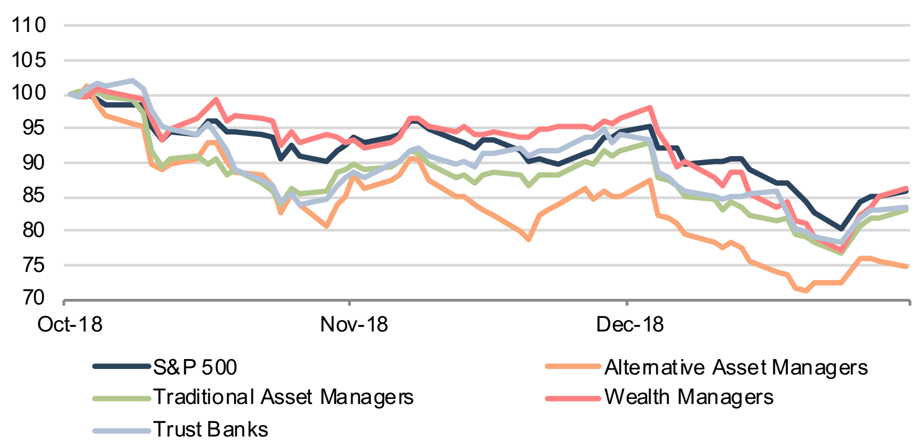
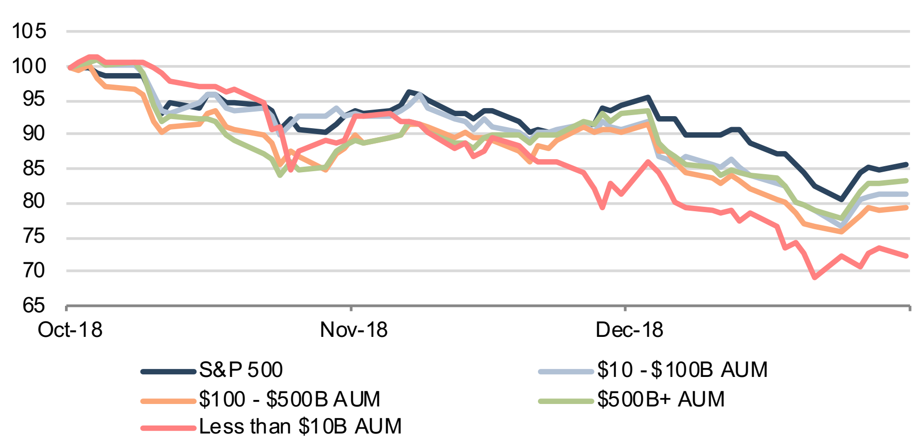


Chart 4 | Investment Management Performance by Size: Q4 2018



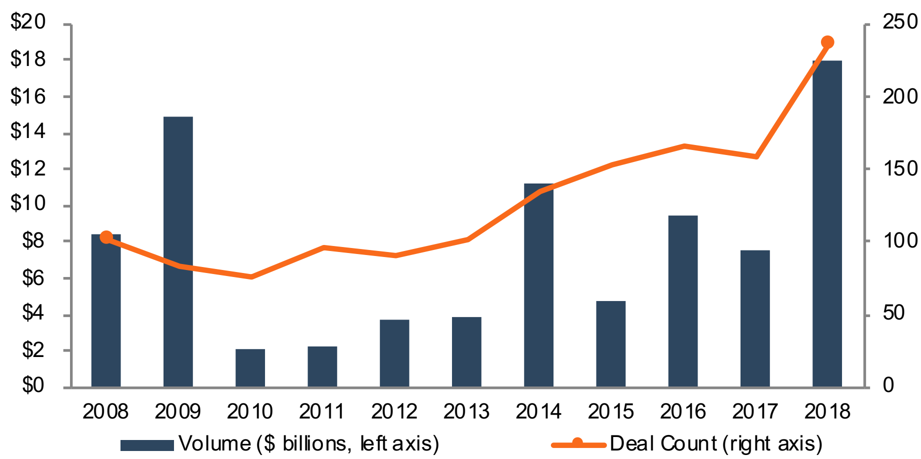
Source: S&P Global Market Intelligence

M&A Trends

2018 Was a Banner Year for Asset Manager M&A

Investment Manager M&A Trends

2008 – 2018



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

M&A was particularly strong in the fourth quarter, when Invesco Ltd. (IVZ) announced plans to acquire the OppenheimerFunds unit from MassMutual for $5.7 billion in one of the largest sector deals over the last decade. IVZ will tack on $250 billion in AUM as a result of the deal, pushing total AUM to $1.2 trillion and making the combined firm the 13th largest asset manager by AUM globally and the 6th largest by retail AUM in the U.S. The deal marks a major bet on active management for IVZ, as OppenheimerFunds' products are concentrated in actively-managed specialized asset classes, including international equity, emerging market equities, and alternative income. Invesco CEO Martin Flanagan explained the rationale for scale during an earnings call in 2017:

"Since I've been in the industry, there's been declarations of massive consolidation. I do think though, this time there are a set of factors in place that weren't in place before, where scale does matter, largely driven by the cost coming out of the regulatory environments and the low rate environments in cyber and alike."

Martin Flanagan
President and CEO, Invesco Ltd.
1Q17 Earnings Call

RIA aggregators continued to be active acquirers in the space, with Mercer Advisors (no relation), and United Capital Advisors each acquiring multiple RIAs during 2018. The wealth management consolidator Focus Financial Partners (FOCS) has been active since its July IPO as well. In August, FOCS announced the acquisition of Atlanta-based Edge Capital Group, which manages $3.5 billion in client assets. FOCS also announced multiple sub-acquisitions by its affiliates during the second half of 2018.

Consolidation Rationales

The underpinnings of the M&A trend we've seen in the sector include increasing compliance and technology costs, broadly declining fees, aging shareholder bases, and slowing organic growth for many active managers. While these pressures have been compressing margins for years, sector M&A has historically been muted, due in part to challenges specific to asset manager combinations, including the risks of cultural incompatibility and size impeding alpha generation. Nevertheless, the industry structure has a high degree of operating leverage, which suggests that scale could alleviate margin pressure as long as it doesn't inhibit performance.

"Absolutely, this has been an elevated period of M&A activity in the industry and you should assume … we're looking at all of the opportunities in the market."

Nathaniel Dalton
CEO, Affiliated Managers Group Inc.
2Q18 Earnings Call

"Increased size will enable us to continue to invest in areas that are critical to the long-term success of our platform, such as technology, operations, client service and investment support, and to leverage those investments across a broader base of assets."

David Craig Brown
CEO & Chairman, Victory Capital
3Q18 Earnings Call

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. Over the past several years, these consolidation rationales have led to a significant uptick in the number of transactions as firms seek to realize economies of scale, enhance product offerings, and gain distribution leverage.

Market Impact

Recent increases in M&A activity come against a backdrop of a long-running bull market in asset prices that finally capitulated in late 2018. Over the past several years, steady market gains have more than offset the consistent and significant negative AUM outflows that many active managers have seen. Now that the market has pulled back, AUM, revenue, and earnings are likely to be lower for many asset managers.

The recent market pullback will impact sector deal making in several ways. Notably, earnings multiples for publicly traded asset managers have fallen considerably during 2018, which suggests that market sentiment for the sector has waned as the broader market has declined. While the lower multiple environment is clearly less favorable for sellers, market volatility may force some smaller, less profitable firms into selling in order to remain viable. For buyers, the lower multiple environment may make the sector look relatively underpriced though some may be spooked by the recent volatility.

M&A Outlook

With over 12,000 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. An aging ownership base is another impetus. The recent market volatility will also be a key consideration for both sellers and buyers in 2019.

Investment Manager Multiples by Sector

				Pricing as of December 31, 2018			
	Ticker	12/31/2018 Stock Price	% of 52 Week High	Price / Trailing EPS	Price / Forward EPS	Enterprise Value / AUM (%)	Enterprise Value / EBITDA
TRADITIONAL ASSET MANAGERS							
Affiliated Managers Group, Inc.	AMG	$97.44	44.9%	10.9x	10.2x	1.07	8.4x
BlackRock, Inc.	BLK	392.82	66.1%	14.6x	14.4x	1.03	10.3x
Legg Mason, Inc.	LM	25.51	54.1%	7.9x	7.6x	0.59	21.7x
Pzena Investment Management, Inc.	PZN	8.65	65.8%	11.2x	10.9x	1.88	7.6x
Westwood Holdings Group, Inc.	WHG	34.00	48.1%	11.0x	nm	1.51	6.4x
Group Median			**54.1%**	**11.0x**	**10.6x**	**1.07**	**8.4x**
MUTUAL FUNDS							
AllianceBerstein Investments, Inc.	AB	$27.32	87.5%	10.9x	10.2x	1.46	nm
Cohen & Steers, Inc.	CNS	34.32	71.8%	14.1x	14.1x	2.78	10.2x
INVESCO Ltd.	IVZ	16.74	43.6%	7.2x	6.6x	1.54	8.7x
Franklin Resources, Inc.	BEN	29.66	64.5%	9.8x	10.4x	1.62	5.0x
Diamond Hill Investment Group, Inc.	DHIL	149.45	68.9%	11.4x	nm	2.16	5.9x
Eaton Vance Corp.	EV	35.18	57.7%	11.2x	11.0x	1.17	8.6x
Hennessy Advisors, Inc,	HNNA	10.01	50.1%	5.1x	nm	1.56	3.3x
Manning & Napier, Inc.	MN	1.76	40.5%	8.8x	7.8x	nm	nm
T. Rowe Price Group, Inc.	TROW	92.32	72.4%	12.6x	12.4x	2.21	8.4x
U.S. Global Investors, Inc.	GROW	1.10	20.3%	nm	nm	1.98	nm
Waddell & Reed Financial, Inc.	WDR	18.08	75.9%	7.9x	8.3x	1.93	4.9x
Federated Investors, Inc.	FII	26.55	72.2%	12.1x	11.8x	0.61	8.0x
Virtus Investment Partners, Inc.	VRTS	79.43	57.5%	6.8x	6.5x	0.94	5.0x
Group Median			**64.5%**	**10.4x**	**10.3x**	**1.59**	**7.0x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, LLC	APO	$24.54	65.7%	nm	nm	2.61	7.4x
Blackstone Group L.P.	BX	29.81	73.4%	29.0x	12.4x	7.68	7.6x
Carlyle Group, L.P,	CG	15.75	60.8%	13.4x	14.7x	4.48	14.8x
Kohlberg Kravis Roberts & Co.	KKR	19.63	68.3%	9.8x	10.5x	24.78	nm
Oaktree Capital Group, LLC	OAK	39.75	84.9%	13.0x	15.7x	10.74	19.2x
Och-Ziff Capital Mgmt Group LLC	OZM	0.92	31.9%	nm	1.2x	4.79	10.3x
Group Median			**67.0%**	**13.2x**	**12.4x**	**6.24**	**10.3x**
TRUST BANKS							
Northern Trust Corporation	NTRS	$83.59	72.3%	12.7x	12.8x	nm	nm
Bank of New York Mellon Corporation	BK	47.07	79.8%	11.3x	11.3x	nm	nm
State Street Corporation	STT	63.07	55.2%	8.7x	8.8x	nm	nm
Group Median			**72.3%**	**11.3x**	**11.3x**	**nm**	**nm**
OVERALL MEDIAN			**65.7%**	**11.1x**	**10.7x**	**1.88**	**8.2x**

Source: Bloomberg
Note: Och-Ziff Capital Management Group (OZM) Q4 Earnings were not yet available at the time this information was prepared which likely results in overly compressed multiples shown above.

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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- 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

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- Fairness Opinions
- 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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