MERCER CAPITAL

VALUE FOCUS

Investment Management

First Quarter 2019 | Segment Focus: Asset Managers

In This Issue

Ordinarily, we'd expect investment manager stocks to outperform the S&P in a stock market rally. This isn't always the case though. So far this year, most classes of RIA stocks have underperformed the market despite its relatively sharp increase through the first three months. The explanation isn't necessarily obvious.

While market declines are a threat to the profitability and valuations of any asset management firm, active managers face the additional headwind of relative underperformance driving outflows, even in periods of rising markets. In this issue's segment focus, we address the extent to which active fund outflows have been driven by mediocre performance versus competition from passive strategies and the impact on asset management firm valuations.

Also in this issue, we address industry M&A trends and the factors driving deal activity, including increasing activity by RIA aggregators and rising cost pressures. Consolidation has been a driver of many of the recent large deals, as exemplified by the largest deal of last year, Invesco's acquisition of OppenheimerFunds.

Market Overview

RIAs Still Reeling from Last Year's Sell-Off

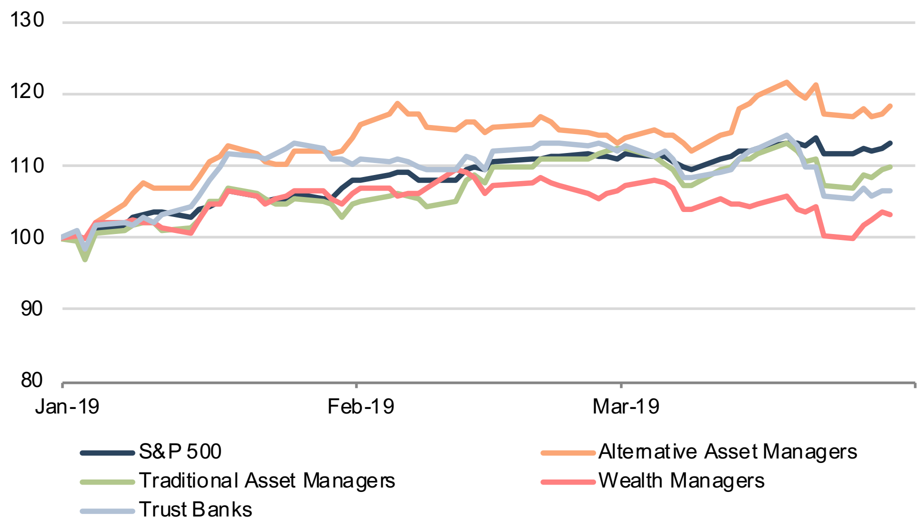
As previously noted, RIA stocks usually outperform the market when it's trending up. When the broader indices creep up, so do AUM and revenue. Higher top line growth typically leads to even greater gains in profitability with the help of operating leverage. Assuming no change in the P/E multiple, RIA stock prices should outpace the market in a bull run.

This isn't always the case though. So far this year, most classes of RIA stocks have underperformed the market despite its relatively sharp increase through the first three months (Chart 1).

The explanation isn't necessarily obvious. Investors are likely still concerned about the industry's prospects in the face of fee compression and continued asset outflows. Alternative asset managers were the sector's sole bright spot as hedge funds tend to do well in volatile market conditions. Still, expanding Chart 1 over the last year shows that they too have underperformed the market over this time (Chart 2).

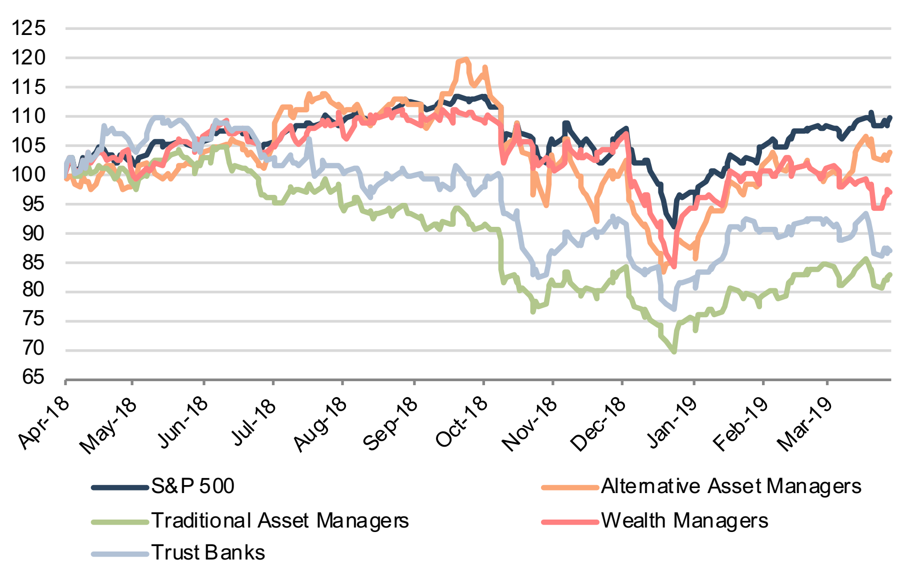
The fallout over this time is primarily attributable to the decline in the (historical) earnings multiple (see the table on **page 4**). Since this multiple is a function of risk and

Chart 1 | Investment Management Performance by Sector: Q1 2019



Source: S&P Global Market Intelligence

Chart 2 | Investment Management Performance by Sector: Twelve Months Ended March 31, 2019



Source: S&P Global Market Intelligence growth, it must be at least one of those factors that's weighing on investors. We believe it is a combination of the two since rising fee pressure and continuing demand for passive products have heightened the industry's risk profile while dampening growth prospects. The forward multiple has recovered some this year, but that's likely attributable to analysts' downward revisions of forward earnings estimates in Q1 after the market decline from the prior quarter.

Traditional asset managers have felt these pressures most acutely, as poorly differentiated products have struggled to withstand downward fee velocity and increased competition from ETF strategies. 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**.

Implications for Your RIA

In all likelihood your investment management firm is much smaller than the public RIAs, many of which have several hundred billion in AUM and thousands of employees across the country. It's also probably unlikely that your business lost 20% of its value last year like most of the public "comps." The market for these businesses was particularly volatile in 2018, and year-end happened to fall at the low end of the range. So far this year, most publicly traded RIAs have recovered some of these losses during more favorable market conditions.

Still, we can't totally ignore what the market is telling us about RIA valuations. We often get pushback from clients for even considering how the market is pricing these businesses (typically as a multiple of earnings) given how large these companies are relative to theirs. The reality though is that your subject company is probably facing the same industry headwinds and competitive pressures that publicly traded RIAs are dealing with. If investors have turned particularly bullish or bearish on the industry's prospects, we have to consider that in our analysis.

A (Less) 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 are 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 the rest of 2019 doesn't look great given what happened to RIA stocks at the end of 2018, but the recent uptick suggests that it's not as bad as it was a few months ago. The market is clearly anticipating lower revenue and earnings following the Q4 correction, which could be exacerbated if clients start withdrawing their investments. On the other hand, more attractive valuations could also entice more M&A, coming off the heels of a **record year in asset manager dealmaking**.

Segment Focus: Asset Managers

Is the decline in active management a result of increased competition or mediocre performance?

As discussed, over the last year, the stock price declines of publicly traded asset managers were generally more significant than other investment managers and the broader stock market.

As mentioned in our latest whitepaper, ***How to Value a Wealth Management Firm***, wealth managers are more resistant to market volatility as shown by their superior performance to asset managers over the last year. Their resilience stems from the fact that client assets are correlated with the market, but client relationships are not.

Asset management firms are more susceptible to market volatility, however, because during periods of volatility or market declines, asset management firms risk losing assets from both downward market movements and client outflows. Downward market movement clearly has a direct negative impact on AUM, but it can also lead to outflows and lower revenue as clients de-risk or reallocate to lower fee fixed income products.

While market declines are a threat to the profitability and valuations of any asset management firm, active managers face the additional threat of relative underperformance driving outflows, even in periods of rising markets. Low fee passive strategies have become increasingly popular due in part to both the perceived underperformance of active managers and an increasing focus on fees. But to what extent have active fund outflows been driven by mediocre performance versus competition from passive strategies, and what is the impact on asset management firm valuations?

Fund Outflows

In general, asset managers are experiencing an industry wide shift away from actively managed investment products. Over the last 15 years, more than **half of all U.S. equity funds** have merged or liquidated. **According to MorningStar**, 2018 was the "worst year for long-term fund flows since 2008." Inflows were less than half the $350 billion average for the prior year, and outflows approximated 4% of beginning assets.

At year end, **Morningstar predicted that if current trends in asset flows continued**, passive U.S. equity funds would likely catch up with active funds' market share in the next few months of 2019. Most of our clients expect this trend will continue for a few more years before stabilizing and possibly reversing at some point. January 2019 brought a more **positive outlook for actively managed funds** which "for the first time in five years outshone their passive counterparts."

Mediocre Performance

Headlines have recently brought attention to the mediocre performance of many active managers ("**Active fund managers trail the S&P 500 for the ninth year in a row**"). One of the primary reasons for active funds' lackluster performance is the number of active funds that participate in closet indexing. Closet indexers claim to manage a unique portfolio designed to generate active returns while their active share (percentage of holdings that differ from the benchmark) is actually quite low. Last year, thirteen active fund managers **agreed to voluntarily disclose their active share** in order to increase transparency. Actively managed funds charge higher fees in exchange for the promise of excess return. Closet indexers typically generate returns in line with the benchmark but at a higher cost than a passive investment in the underlying benchmark.

Competition from Passive Alternatives

According to **Morningstar's semiannual Active/Passive Barometer** (published in February), "just 38% of active U.S. stock funds survived and outperformed their average passive peer in 2018, down from 46% in 2017." For the twenty years ending December 2015, the S&P 500 index averaged 9.85% a year **while the average equity fund investor earned** a return of only 5.19%. There has been much written about the shift from active to passive investing, and high costs and active manager underperformance are largely to blame.

Asset Manager Pricing Information

Median	Price as % of 52 Week High	Price / Trailing EPS	Price / Fwd EPS
1Q 2019	71.5%	10.5x	12.0x
4Q 2018	61.1%	10.9x	10.4x
3Q 2018	74.7%	11.0x	11.6x
2Q 2018	79.9%	11.8x	11.2x
1Q 2018	89.3%	15.8x	12.4x
YoY Change	***-19.9%***	***-33.6%***	***-3.3%***

Source: Bloomberg

Valuations

On average the stock prices of asset managers fell 17% year-over-year. Trailing valuations fell by over 30% from a median of 15.8x trailing earnings in March 2018 to 10.5x trailing earnings in March 2019. The broader stock market has recovered somewhat from the pullback observed at year end, but asset manager valuations have improved more modestly. Forward multiples, however, are more in line with historical norms.

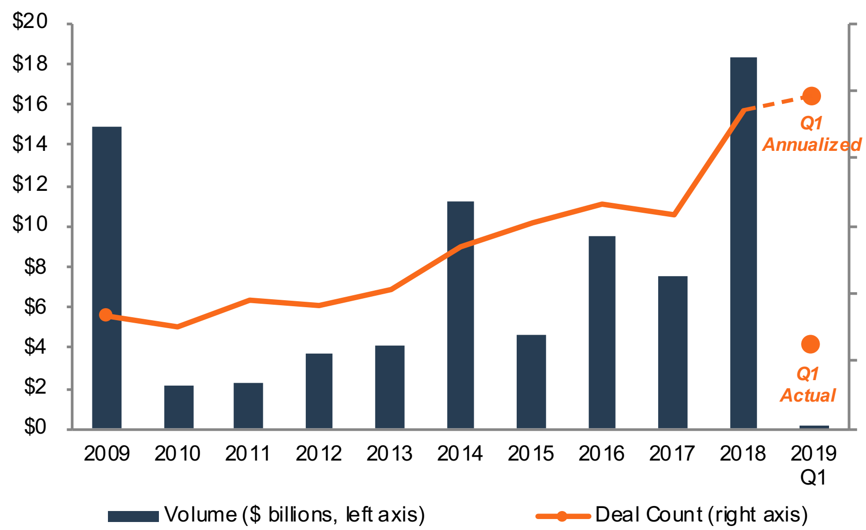
Is the decline in active management a result of increased competition or mediocre performance? We think it's both. In general, clients (especially institutional investors and high net worth individuals) are still willing to pay for superior performance. We think best-in-class asset managers could come out ahead of their passive counterparts in the long run, but the problem is that best-in-class asset managers are, by definition, few and far between.

M&A Trends

On the heels of a record year, will asset manager M&A trends continue strong in 2019?

Investment Manager M&A Trends

2008 – Q1 2019



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

2018 was the busiest year for asset manager M&A in the last decade, and the trend is poised to continue into 2019 as business fundamentals and consolidation pressures continue to drive deal activity. Several trends that have driven the uptick in sector M&A in recent years have continued into 2019, including increasing activity by RIA aggregators and rising cost pressures. Total deal count during the first quarter of 2019 was flat compared to the same period in 2018, while deal count was up 35% for the twelve months ending March 31, 2019, compared to the comparative period ending March 31, 2018. Reported deal value during the first quarter of 2019 was down significantly, although the quarterly data tends to be lumpy and many deals have undisclosed pricing.

Consolidation has been a driver of many of the recent large deals, as exemplified by the largest deal of last year, Invesco's (IVZ) acquisition of OppenheimerFunds. IVZ announced plans in the fourth quarter last year 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's 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. So far in 2019, FOCS has announced 11 deals (including acquisitions by its partner firms). In April, Silvercrest Asset Management announced the acquisition of Cortina Asset Management, a $1.7 billion small cap growth equity manager based in Milwaukee, Wisconsin.

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.

Another emerging trend that has been driving deal volume is the rise of minority interest deals by private equity or strategic buyers. These deals solve or mitigate many of the problems associated with acquisitions of what are normally "owner operated" businesses (at least for smaller RIAs). Minority interest deals allow sellers to monetize a portion of their firm ownership (often a significant portion of their net worth). From the buyer's perspective, minority interest deals ensure that management remains incented to continue to grow the business after the deal closes.

Market Impact

Deal activity in 2018 was strong despite the volatile market conditions that emerged in the back half of the year. Equity markets have largely recovered and trended upwards in the first quarter of 2019. Publicly traded asset managers have lagged the broader market so far in 2019, suggesting that investor sentiment for the sector has waned after the volatility seen at year-end 2018.

M&A Outlook

With over 11,000 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 and margin compression. 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

	Ticker	3/29/2019 Stock Price	% of 52 Week High	Pricing as of March 29, 2019 Price / Trailing EPS	Price / Forward EPS	Enterprise Value / AUM (%)	Enterprise Value / EBITDA
TRADITIONAL ASSET MANAGERS							
Affiliated Managers Group, Inc.	AMG	$107.11	57.7%	11.6x	11.8x	1.23	10.0x
Artisan Partners Asset Management Inc.	APAM	25.17	78.9%	8.8x	9.9x	2.04	6.3x
BlackRock, Inc.	BLK	427.37	78.4%	15.9x	15.4x	1.13	11.8x
Cohen & Steers, Inc.	CNS	42.27	99.4%	17.4x	17.1x	3.65	13.4x
Diamond Hill Investment Group, Inc.	DHIL	140.00	71.2%	9.4x	nm	2.45	7.1x
Eaton Vance Corp.	EV	40.31	70.5%	13.1x	12.8x	1.36	10.3x
Federated Investors, Inc.	FII	29.31	91.4%	13.2x	11.9x	0.68	9.0x
Franklin Resources, Inc.	BEN	33.14	97.3%	11.0x	13.5x	1.89	5.8x
Hennessy Advisors, Inc,	HNNA	9.25	47.7%	4.7x	nm	1.44	3.1x
INVESCO Ltd.	IVZ	19.31	63.6%	8.3x	8.5x	1.68	10.8x
Legg Mason, Inc.	LM	27.37	70.1%	8.5x	18.0x	0.61	22.5x
Manning & Napier, Inc.	MN	2.08	60.2%	10.4x	11.9x	nm	nm
Pzena Investment Management, Inc.	PZN	8.09	78.2%	10.3x	11.1x	1.77	7.5x
T. Rowe Price Group, Inc.	TROW	100.12	80.7%	13.7x	14.1x	2.41	9.2x
U.S. Global Investors, Inc.	GROW	1.09	34.7%	nm	nm	1.95	nm
Virtus Investment Partners, Inc.	VRTS	97.55	71.8%	9.0x	7.7x	1.03	6.0x
Group Median			**71.5%**	**10.4x**	**11.9x**	**1.68**	**9.1x**
WEALTH MANAGERS							
AllianceBerstein Investments, Inc.	AB	28.89	93.9%	11.6x	11.8x	1.54	nm
GAMCO Investors, Inc.	GBL	20.48	72.6%	4.3x	nm	1.68	3.5x
Silvercrest Asset Management Group	SAMG	14.25	80.3%	11.0x	nm	1.00	6.1x
Waddell & Reed Financial, Inc.	WDR	17.05	81.8%	7.4x	11.3x	1.80	4.7x
Westwood Holdings Group, Inc.	WHG	35.27	59.9%	11.4x	nm	1.58	6.7x
Group Median			**80.3%**	**11.0x**	**11.5x**	**1.58**	**5.4x**
ALTERNATIVE ASSET MANAGERS							
Apollo Global Management, LLC	APO	28.25	80.2%	nm	10.6x	3.17	50.6x
Blackstone Group L.P.	BX	34.97	89.4%	34.8x	14.6x	8.19	10.4x
Carlyle Group, L.P,	CG	18.28	76.3%	15.5x	9.3x	4.61	15.2x
Kohlberg Kravis Roberts & Co.	KKR	23.49	82.6%	11.7x	13.8x	25.87	nm
Oaktree Capital Group, LLC	OAK	49.65	99.8%	16.3x	14.7x	12.68	22.7x
Och-Ziff Capital Mgmt Group LLC	OZM	16.41	64.1%	nm	5.6x	5.67	nm
Group Median			**81.4%**	**15.9x**	**12.2x**	**6.93**	**19.0x**
TRUST BANKS							
Bank of New York Mellon Corporation	BK	50.43	88.1%	12.1x	12.4x	nm	nm
Northern Trust Corporation	NTRS	90.41	79.6%	13.7x	13.6x	nm	nm
State Street Corporation	STT	65.81	64.6%	9.1x	9.8x	nm	nm
Group Median			**72.1%**	**12.1x**	**12.4x**	**nm**	**nm**
OVERALL MEDIAN			**78.3%**	**11.4x**	**11.9x**	**1.78**	**9.1x**

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

- Registered Investment Advisors
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- Wealth Management Firms
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- 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

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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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