UNDERSTAND THE VALUE OF YOUR

TRUST COMPANY

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The rapid expansion and contraction of the financial services industry over the past two decades has given rise to a unique hybrid enterprise: the independent trust company. With roots in the departments of commercial banks, independent trust companies occupy a unique space in the financial services industry: positioned somewhere between a family office and an institutional asset manager. Most trust companies share attributes of both family offices and asset managers, so there really is no one-size-fits-all definition of an independent trust company. Recognizing the particular characteristics of any given trust company is essential to understanding its value in the marketplace.

THE BUSINESS TRANSFER MATRIX

Like all private companies, ownership interests in independent trust companies eventually transact. Some of these transactions are voluntary, and some are involuntary, but whatever the case, these transactions tend to be among the most important of the owner's business life.

The table below depicts events ranging from voluntary transfers such as gifts to family members or an outright sale to a third party to involuntary transfers such as those precipitated by death or divorce. An understanding of the context of valuing your business is an important component in preparing for any of these eventualities.

The Business Transfer Matrix	**PARTIAL SALE/TRANSFER**	**TOTAL SALE/TRANSFER**
THINGS YOU MAKE HAPPEN	ESOP Outside Investor(s) Sale to Insiders/Family Combination Merger/Cash Out Going Public	Sale of Business Stock-for-Stock Exchange w/ Public Co. Stock Cash Sale to Public Co. Installment Sale to Insiders/Family ESOP/Management Buyout
THINGS THAT HAPPEN TO YOU	Death Divorce Forced Restructuring Shareholder Disputes	Death Divorce Forced Restructuring Bankruptcy

Mercer Capital provides asset managers, trust companies, and investment consultants with corporate valuation, financial reporting valuation, transaction advisory, portfolio valuation, and related services.

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INDUSTRY CONDITIONS & ISSUES

As high net worth clients migrated from the traditional sales mentality investment approach of brokerage firms and began transitioning assets away from the larger wire house businesses, the idea of independent investment advisors began to gain steam. The financial advisory business model transformed from cold calling staffs paid by transaction-based commissions to credentialed professionals paid on the basis of assets under management, or AUM. The popularity of Registered Investment Advisors, or RIAs, centered on the fiduciary responsibility associated with such practices, as well as the greater degree of accessibility and high touch nature of its business operations, which often originated in a family office type setting. Additionally, the smaller size of independent advisors allowed for greater innovation and more specialized services. The number of total investment advisors registered with the SEC has nearly doubled from 6,360 in 1999 to 11,539 in 2011[1] (excluding all investment advisors only required to register with their respective states). Parallel to the proliferation of RIAs is the rise of state-regulated independent trust banks in the wake of mega-bank mergers and bailouts following the financial crisis of 2008. Major financial institutions lost both the trust and the assets of many individual investors, as these sought more personalized levels of service and a non 1-800 number for a qualified financial advisor. Independent trust companies and community banks were more than happy to fill this void and have since capitalized on disenchanted investors seeking a closer relationship with their trustees.

In spite of all the changes taking place in recent years, there remains some debate regarding whether the independent trust industry is mature or evolving. The concept of providing comprehensive trust and estate administration within the context of highly personalized customer service is not new, but the level of sophistication expected across the spectrum of fiduciary services has never been higher and, indeed, seems to be growing at a rapid pace.

RULES OF THUMB

There are both formal and informal approaches to value, and while we at Mercer Capital are obviously more attuned to the former, we don't ignore the latter. Industry participants often consider the value of investment managers and independent trust companies using broad-brush metrics referred to as "rules-of-thumb." Such measures admittedly exist for a reason, but cannot begin to address the facts and circumstances specific to a given enterprise.

Understanding why such rules-of-thumb exist is a good way to avoid being blindly dependent on them. During periods of consolidation, buyers often believe that the customer base (or AUA in the case of an independent trust company) of an acquisition candidate can be integrated with the acquiring firm's existing client assets to generate additional profits in line with industry expectations. So if most independent trust companies are priced at, say, 10x earnings and profit margins are 20%, the resulting valuation multiple of revenue is 2.0x. If revenue is generated by average fees of 50 basis points of assets under administration, then the implied valuation is about 1% of AUA. Note, however, all the "ifs" required to make the 1% of AUA rule of thumb work.

As with other businesses, the revenue of independent trust companies is a function of price times quantity. In this case, price represents the rate charged for assets under administration, and quantity reflects the asset base

1 "2011 Evolution Revolution Report," Online, Available http://mer.cr/PCIXio

or AUA for independent trust companies. Value, however, is related to profits which can only be derived after realizing the costs associated with delivering the trust administration services. High priced services are typically more costly to deliver, so margins may fall within an expected range regardless of the nature of the particular company. Still, larger asset managers generally realize better margins, so size tends to have a compounding effect on value.

Activity ratios (valuation multiples of AUM, AUA, revenue, etc.) are ultimately the result of some conversion of that activity into profitability at some level of risk. If a particular trust company doesn't enjoy industry margins (whether because of pricing issues or costs of operations), value may be lower than the typical multiple of revenue or AUA. On a change of control basis, a buyer might expect to improve the acquired company's margins to industry norms, and may or may not be willing to pay the seller for that opportunity.

In the alternative case, some companies achieve sustainably higher than normal margins which justify correspondingly higher valuations. But the higher levels of profitability must be evaluated relative to the risk that these margins may not be sustainable. Whatever the particulars, our experience indicates that valuation is primarily a function of expected profitability and only indirectly related to level of business activity. So rules-of-thumb, if used at all, should be employed with an appropriate level of discretion.

As an example of this, industry participants might consider independent trust companies as being worth some percentage of assets under administration or AUA. At one time, trust bank valuations were thought to gravitate toward about 1% of AUA. The example below demonstrates the problematic nature of this particular rule of thumb for two trust companies of similar size but widely divergent fee structures and profit margins.

RULES OF THUMB & TRUST COMPANIES

	TrustCo A	TrustCo B
Assets Under Administration (AUA)	$1,000,000,000	$1,000,000,000
x Average Fee	**0.5%**	**0.2%**
= Revenue	$5,000,000	$2,000,000
x EBITDA Margin	**25.0%**	**10.0%**
= EBITDA	$1,250,000	$200,000
Implied Value at 1% of AUA	$10,000,000	$10,000,000
Effective Multiple of EBITDA	**8**	**50**

TrustCo A charges a higher average fee and is significantly more profitable than TrustCo B despite having identical AUA balances. Because of these discrepancies, TrustCo A is able to generate over 6x the profitability of its counterpart. Application of the 1% rule yields a $10 million valuation for both businesses, an effective EBITDA multiple of 8x for TrustCo A and 50x for TrustCo B. While 1% of AUA, or 8x EBITDA, may be a reasonable valuation for TrustCo A, it is no way representative of a rational (non-synergistic) market participant's realistic appraisal of its counterpart since it would imply an effective EBITDA multiple of 50x. It is our experience that trust companies with higher asset balances, fees structures, and profit margins typically attract higher AUA multiples in the marketplace. Still, the fact that many trust companies have a blend of AUA and AUM with differing fee structures renders the application of any asset based multiple less reliable in these circumstances.

BACKGROUND CONCEPTS OF "VALUE"

The industry issues discussed above can and should impact the valuation of independent trust companies. But a professional valuation practitioner considers other issues as well.

Many business owners are surprised to learn that there is not a single value for their business or a portion of their business. Numerous legal factors play important roles in defining value based upon the circumstances related to the transfer of equity ownership. While there are significant nuances to each of the following topics, our main goal is to help you combine the economics of valuation with the legal framework of a transfer (whether voluntary or involuntary).

Valuation Date

Every valuation has an "as of date" which, simply put, is the date at which the analysis is focused. The date may be set by legal requirements related to a certain event, such as death or divorce, or may be implicit, such as the closing date of a transaction.

Purpose

The purpose of the valuation is important. A valuation prepared for one purpose is not necessarily transferable to another. The purpose of the valuation is likely to determine the "standard of value."

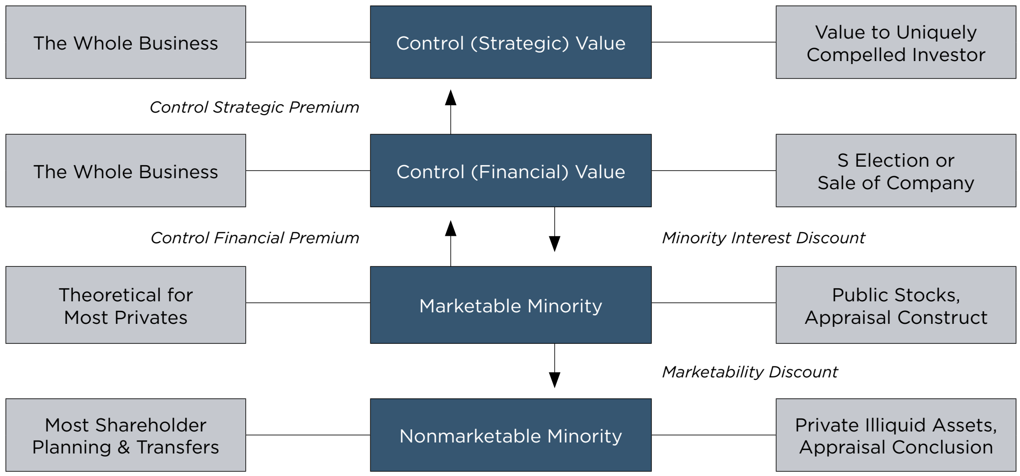
Standard of Value

The standard of value is an important legal concept which influences the selection of valuation methods and the level of value. There are many standards of value, the most important being fair market value, which is most commonly used in tax matters. Other important standards include investment value (purchase and sale transactions), statutory fair value (corporate reorganizations), and intrinsic value (public securities analysis). Using the proper standard of value is crucial in obtaining an accurate determination of value.

Levels of Value

When business owners think about the value of their business, the value considered relates almost always to the business in its entirety. From this perspective, the value of a single share is the value of the whole divided by the number of outstanding shares. In the world of valuation, however, this approach is not appropriate if the aggregate block of stock does not have control of the enterprise; in this case, the value of a single share will be less than the whole divided by the number of shares.

Although the determination of whether the valuation should be on a controlling interest or minority interest basis can be a complex process, it is of great importance. A minority interest value often includes discounts for a lack of control and marketability; therefore, it is quite possible for a share of stock valued as a minority interest to be worth far less than a share valued as part of a control block. Grasping the basic knowledge related to these issues can help you understand the context with which the value of a business interest is developed.



TYPICAL APPROACHES TO VALUATION

Within the common valuation lexicon, there are three approaches to valuing a business: the asset approach, income approach, and market approach.

The Asset Approach

The various methodologies that fall under the umbrella of the asset approach involve some market valuation of a subject company's assets net of its liabilities. In the case of a trust company, the primary "assets" of the business get on the elevator and go home every night. In some contexts, it may be useful to evaluate the worth of a company's trade name, workforce intangible, customer list, or other intangible assets. But typically the value of any professional services firm, including independent trust companies, is usually better expressed via the income and market approaches.

The Income Approach

The income approach usually follows one of two methodologies, a discounted cash flow method or a single period capitalization method. The discounted cash flow methodology (or DCF) requires projecting the expected profitability of a company over some term and then "pricing" that profitability using an expected rate of return, or discount rate. Single period capitalization models generally involve estimating an ongoing level of profitability which is then capitalized using an appropriate multiple. In either case, the income approach requires a thorough analysis of the risks and opportunities attendant, and in the case of valuing trust companies, it can be a useful arena to delineate issues unique to the industry and that of the particular company.

Within the spectrum of asset managers, entities styled as family office operations may exhibit lower growth (which all else equal would suggest lower valuations) but also more stable client bases (with higher probability of recurring revenue, which tends to raise valuations). On the other end of the spectrum, valuing a hedge fund manager might require balancing the potential for supernormal earnings growth with supernormal earnings volatility.

An independent trust company would typically fall somewhere in between these two extremes. Independent trust companies tend to enjoy a high degree of customer loyalty, but at the price of lower margins expected in a multi-discipline, high-touch business where client expectations for technical expertise and customer service compound staffing costs. There are similar opportunities for earnings leverage as with any asset manager, but these can be tempered by the nature of services that trust companies provide.

The Market Approach

Of the three approaches to value, the market approach may be the most compelling due to the high availability of pricing data. The market approach can be accomplished in a number of ways, looking at the valuation multiples implied by outright sales of similar businesses or observing the trading activity in shares of publicly held companies.

While the market approach can be the most useful way to value trust companies, it can also be the most misused. While it is possible to find transactions involving investment management companies or publicly traded trust banks and RIAs that are similar to a given independent trust company, it is also important to understand and isolate what is different about the subject company that can affect value.

Market data also has drawbacks. Transactions data may offer limited information about multiples paid for various measures of profitability, and there may be no real way to isolate potential synergies reflected in the transaction pricing that might have been unique to the buyer and seller. Publicly traded investment management firms and trust banks offer more thorough and consistent data, but they tend to be much larger and more diversified than independent trust companies.

The potential differences in margin and product line have already been discussed in this article, but smaller independent trust companies also tend to exhibit greater dependence on certain managers or clients, the loss of which could be difficult to replace without a detrimental impact on the financial returns of the business. Narrow product offerings or problems in the economic area served by the trust company could also constrain growth opportunities. Of course, it's also possible that a subject enterprise might have a better than market opportunity because of a particular customer base served or a particular product offering.

In any event, the valuation multiples implied by transaction activity or public investment management companies may and often do require some adjustment for various factors before being applied to the valuation of the subject trust company.

PUTTING IT ALL TOGETHER

Valuation analysis is not complete if it is left untested. In the valuation of trust companies, whatever methodologies are employed should ultimately reconcile to a conclusion of value that is reasonable given expectations for the company relative to pricing in the industry. This might ultimately fit within some kind of rule of thumb, but only by coincidence. Experience has taught us that in the wealth management industry, as elsewhere, maximizing opportunity and minimizing risk enhances value.

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ABOUT MERCER CAPITAL

Mercer Capital is a full-service business valuation and financial advisory firm. We offer a broad range of services, including corporate valuation, financial institution valuation, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting. We have provided thousands of valuation opinions for corporations of all sizes in a wide variety of industries. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. For over 30 years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world.

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Mercer Capital provides asset managers, trust companies, and investment consultants with corporate valuation, financial reporting valuation, transaction advisory, portfolio valuation, and related services. Our quarterly e-mail newsletter, **Value Focus: Asset Management Industry**, highlights a market segment in each issue: 1st Quarter - Mutual Fund Companies; 2nd Quarter: Traditional Asset Managers; 3rd Quarter - Alternative Asset Managers; and 4th Quarter - Trust Banks.

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