

# Valuation of Independent Trust Companies

**Mercer Capital**

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## SUMMARY

In this whitepaper we review the history of trust companies and how consolidation in the banking industry, changing consumer preferences, and favorable trust law changes have led to the proliferation of independent trust companies. We analyze the average trust company's income statement and industry-wide trends, such as trust companies' relative immunity to fee pressure. We consider valuation "rules-of-thumb," and why they often fail to address the issues specific to a given firm. Finally, we consider the various valuation methodologies, including the use of discounted cash flow models and guideline public company analysis, and how the use of multiple valuation approaches can serve to generate tests of reasonableness against which the different indications can be evaluated.



Because valuation is a relative concept (one asset is only “worth” something when compared to the worth of other assets), the value of an independent trust company is very much about context. The particular transactional purpose of a valuation is a context. The firm being valued is a context. The state of the trust administration and investment management industries is a context. Each context provides a perspective on the expected returns of an investment in a trust company.

This whitepaper is intended to give a brief overview of relevant considerations of these perspectives on the value of trust companies. It is not intended to be an exhaustive presentation of every consideration, but as the industry has matured, so has the understanding of most participants that simply saying firms are worth “2% of AUM/AUA” is not enough. As professional valuation practitioners, we always viewed such rules of thumb with caution, and welcome the attitudes of those who take the financial analysis of their own firms as seriously as they do the analysis of the assets they manage for clients.

## **A BRIEF HISTORY OF THE TRUST INDUSTRY**

Historically, the role of a trust was simply for one party (the trustee) to hold property for the benefit of another (the beneficiary). Over time, the role of trust companies has expanded to include managing the distribution, administration, and investment of trust assets. Fifty years ago, most local banks had a trust officer who performed these services. Consolidation in the banking industry, changing consumer preferences, and favorable trust law changes in states such as Delaware, Nevada, and South Dakota have led many bank trust officers to leave their local bank and start independent trust companies. (This shift parallels the shift from the broker-dealer to independent RIA model.)

As trusts have become more sophisticated, independent trust companies have become increasingly specialized with respect to trust administration. Many independent trust companies today focus on specialized types of trusts or beneficiaries. As part of this trend, trust companies are increasingly outsourcing investment management to better focus on fiduciary issues.

More trust companies are now shifting to a directed trustee model, which absolves the trustee of certain fiduciary responsibilities. With a directed trust an investment advisor is named on the account so that investment decisions are made by the appointed advisor rather than the trust company. This allows the trust company to focus on fiduciary issues related to trust and estate administration rather than investment management. Typically, a directed trustee model calls for slightly lower fees, but much less liability for the trust company.

The alternative is a delegated trustee model, where the trustee can delegate fiduciary authority to an investment advisor as they see fit. However, in this model, the trustee is responsible for properly vetting the investment advisor and supervising their decisions.

## OVERVIEW OF TYPICAL TRUST COMPANY P&L

As with other industries, trust company revenue can be broken down into price and quantity. In the context of trust companies, quantity is measured by the value of AUA and price is measured by the realized fee structure.

In the U.S., there are about \$1.2 trillion in total personal trust assets, a growing portion of which is administered by independent trust companies. On average, independent trust companies administer \$1.5 billion each. Generally, AUA growth has been highest within the non-managed (delegated or directed) trustee model.

Trust companies typically charge fees based on a percentage of AUA. A trust company's effective realized fee level (calculated as revenue divided by average AUA over the period during which that revenue as earned) represents the price at which the trust company is selling its services. Like all market-driven prices, effective realized fees are determined by demand and supply equilibrium, which is driven by factors like the cost of providing services, the perceived value proposition of the product, the availability of substitute products, and the level of competition in the industry.

Wealth Advisor reported that on average corporate trustees charge around 50 basis points per year for vanilla trust services. Trust companies typically don't require minimum account sizes, but instead require minimum annual fees, which can range from \$1,000 to \$20,000 depending on the services offered. Fees are typically structured on a sliding scale, where the first million could be charged 60 bps, the next million could be charged 50 bps, and the next million 40 bps, etc. If the trust company also manages the underlying assets, fees will of course be higher. However, larger clients tend to receive discounts, which can correspond to low fees by industry standards, but substantial revenue given the size of the account.

The relationships between independent trust companies and their clients require the time and energy of a dedicated staff. Thus, most of a typical independent trust company's expenses are personnel expenses, which include salaries, bonuses, and other benefits for employees and officers.

Overhead costs for trust companies are generally fixed in nature, which allows trust companies to take advantage of operating leverage over time. Overhead costs include the cost of compliance, technology, and marketing expenditures, all which have been increasing over the last few years. We have seen an increased focus on branding as trust companies seek to connect with clients on a more personal level. Additionally, corporate trusts can have significant litigation costs from year to year.

## HOW DOES YOUR TRUST COMPANY MEASURE UP?

Bringing everything together, the average trust company's income statement looks similar to the one outlined below.

| Average Trust Company Metrics |                 |
|-------------------------------|-----------------|
| Average AUA                   | \$1,508,788,743 |
| x Implied Fees                | 0.466%          |
| Average Revenue               | 7,033,634       |
| x Average Operating Margin    | 36.90%          |
| Average Operating Profit      | \$2,595,411     |

Source: Pohl Consulting, Trust Compare 2018 Data

Charging slightly under 50bp on \$1.5 billion in assets, the average trust company generated \$7.0 million in revenue in 2019. With an average operating margin of approximately 37%, the average independent trust company had \$2.6 million in operating profit to distribute to shareholders or invest in new technology or marketing initiatives.

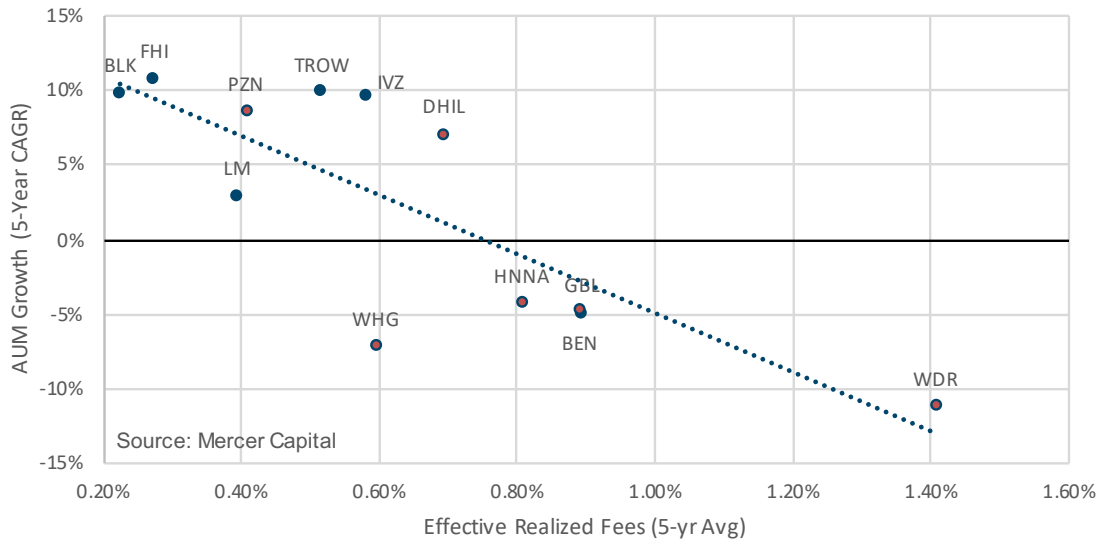
## TRENDS WITH INDEPENDENT TRUST COMPANIES

Independent trust companies are a growing segment of the trust industry. While trust divisions of banks still represent about 84% of the trust industry, there's been a trend towards independence that parallels the wealth management industry. We highlight some of the trends impacting independent trust companies below.

### Fees

Over the last decade, 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. Virtually all discount brokerages were forced to cut trading fees to zero. Consider the relationship between effective realized fees and revenue growth over the last five years for US asset/wealth managers (shown in the chart on page 4). The message is clear. Assets across the financial services industry are gravitating towards lower fee products.

Effective Realized Fees vs 5-Year AUM Growth for U.S. Asset/Wealth Managers



Despite the pricing pressure in the broader industry, trust companies have fared remarkably well. According to Wealth Advisor’s 2019 pricing survey, trust company fees are actually heading higher. Independent trust companies in particular have been more willing than bank trust departments to increase fees. Thus, as customers move assets from trust departments to independent trust companies, we expect fees across the industry will continue increasing.

## Market Movements

The recent coronavirus induced sell-off will have 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. Prices for most risk assets have recovered significantly from late-March levels, but they still remain below all-time highs. Trust company revenue will take a hit. The effect on trust company profitability will depend on the length and severity of the economic slowdown caused by the pandemic and containment policies. The range of likely scenarios is beyond the scope of this whitepaper, but it suffices to say that there is still significant uncertainty regarding the impact on people, markets, and economic activity.

Unlike many asset and wealth management firms, trust companies often have revenue sources that aren’t based on AUM / AUA (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 pandemic.

## Demographics

Trust companies primarily serve high net worth and ultra-high net worth clients, and demographic trends in these markets are favorable for the continued growth of the trust company industry. The number of high net worth individuals (net worth > \$1 million) in the United States has grown significantly over the

last decade. According to Credit Suisse's Global Wealth Report 2019, there were over 18 million millionaires in the United States in 2019, nearly double the number in 2010.

Additionally, the impending wealth transfer as baby boomers age should spur growth in trust assets. Roughly \$30 trillion is expected to change hands between baby boomers and younger generations during the coming years. To the extent that this wealth is transferred via trusts, trust companies stand to benefit.

## 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 by 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 direct 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—the trust company acts as a fiduciary, and the investment advisor is responsible for investment decisions.

## Technology

Trust administration is labor intensive, and requires extensive tax, accounting, legal and compliance expertise. Trust companies typically employ CPAs, estate planning attorneys, financial advisors, and trust officers, among other professionals. Many of our trust company clients have spent substantial amounts of money developing software and systems to reduce the administrative and compliance burden on staff members and enable fewer employees to administer more assets. We expect this trend to continue as trust companies seek to reduce overhead expenses and improve profitability. Trust company clients should benefit as well from reduced friction and improved client experience.

## Succession

The ownership profile at independent trust companies is often similar to asset and wealth management firms. Ownership is often concentrated among the founders, with younger partners owning minority positions. We've written in the past about **buy-sell agreements for wealth management firms**, and much of that discussion is applicable to independent trust companies as well. In short, 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 runs the risk of becoming a costly distraction. As the trust company profession ages, we see transition planning as either a competitive advantage (if done well) or a competitive disadvantage (if disregarded).

## Looking Forward

Many trust companies have performed remarkably well over the last decade, aided by the recently ended 11-year bull market and the trends discussed above. The current market environment is one of incredible uncertainty, and the outlook for trust companies and the economy as a whole will continue to evolve rapidly over the coming months.



# WHEN YOU NEED A VALUATION

If you've never had your independent trust company valued, you probably will eventually. That need may arise because of a circumstance you intended, or it may be because of a circumstance that was forced upon you. Whether voluntary or involuntary, the situation giving rise to the need for a valuation could be one of the most important of your professional career.

| OWNERSHIP TRANSFER MATRIX | Partial Sale/Transfer   | Total Sale/ Transfer   |
|---------------------------|---|--|
| Voluntary Transfers       | ESOP<br>Outside Investor(s)<br>Sales to Insiders/ Relatives<br>Combination Merger/Cash Out<br>Going Public<br>Gifting Programs<br>Buy-Sell Agreements | Sale of Business<br>Stock-For-Stock Exchange w/ Public Company<br>Stock Cash Sale to Public Company<br>Installment Sale to Relatives/ insiders<br>ESOP Management/ Buyout<br>Buy-Sell Agreements |
| Involuntary Transfers     | Divorce<br>Forced Restructuring<br>Shareholder Disputes<br>Buy-Sell Agreements  | Death<br>Divorce<br>Forced Restructuring<br>Bankruptcy<br>Shareholder Disputes<br>Buy-Sell Agreements  |

In our practice, independent trust companies usually need valuations for one of three reasons: shareholder agreements, transactions, and litigation.

## Shareholder Agreements

Simply put, a buy-sell agreement establishes the manner in which shares of a private company transact under particular scenarios. Ideally, it defines the conditions under which it operates, describes the mechanism whereby the shares to be transacted are priced, addresses the funding of the transaction, and satisfies all applicable laws and regulations.

These agreements aren't necessarily static. In trust companies, buy-sell agreements may evolve over time with changes in the scale of the business and breadth of ownership. When firms are new and more "practice" than "business," these agreements may serve more to decide who gets what if the partners decide to go separate ways. As the business becomes more institutionalized, and thus more valuable, a buy-sell agreement – properly rendered – is a key document to protect the shareholders and the business (not to mention the firm's clients) in the event of an ownership dispute or other unexpected change

in ownership. Ideally, the agreement also serves to provide for more orderly ownership succession, not to mention a degree of certainty for owners that allows them to focus on serving clients and running the business instead of worrying about who gets what benefit of ownership.

## Transactions

We are witnessing significant M&A activity in the investment management industry as one generation of business owners prepares for retirement with and without having planned for a successful ownership transition from one generation of business leaders to the next.

Valuations and financial analysis for transactions encompass a refined and scenario-specific framework. The valuation process should enhance a buyer's understanding of the cash flows and corresponding returns that result from purchasing or investing in an independent trust company. For sellers or prospective sellers, valuations and exit scenarios can be modeled to assist in the decision to sell now or later and to assess the adequacy of deal consideration. Setting expectations and defining deal limitations are critical to good transaction discipline.

Even those not currently contemplating a transaction in their stock have a reason to consider a business valuation because knowing the value of your firm can be a tremendously effective management tool.

Ultimately, you will get two returns from your business – “interim cash flows” and “terminal cash flows.” Interim cash flows include your salary, your benefits, and your dividends. You know what these are and what you can do to influence them. However, your greatest cash flow may be the terminal cash flow (i.e., the value when you sell your business). Therefore it is important to ask, **are you managing your business in a way that increases value or not?**

## Disputes

Unlike most closely-held businesses which are owned by members of the same family, most independent trust companies are owned by unrelated parties. A greater than normal proportion of these businesses are very valuable, such that there is more at stake in ownership than most closely held businesses. Consequently, when disputes arise over the value of ownership in an independent trust company, there is usually more than enough cash flow to fund the animosity, and what might be a five figure settlement in some industries becomes a seven figure trial. The need for a valuation may arise out of deficiencies in your buy-sell agreement, the divorce of one of your primary shareholders, or in the case that the business has been damaged as a result of a “bad actor”. In litigious circumstances, the rules and the standards for due diligence and work product are subject to a high level of scrutiny, and the skillset required of the appraiser is equally high.

*Beware that many valuations (most in our experience) performed by industry advisors and some inexperienced business appraisers do not meet the requirements of the business valuation standards of many professional appraisal societies.*



## Stay Updated on How Current Events Are Affecting the Value of Your RIA



### Value Focus: Investment Management Newsletter

Mercer Capital's investment management industry team produces a complimentary quarterly newsletter. Each quarter has a different sector focus and contains an industry market overview, a review of recent transactions, and tracks multiples by industry sector. To view the current issue and the archives or to subscribe to receive the quarterly newsletter, visit <http://mer.cr/RIA-nl>.

# WHO SHOULD VALUE YOUR INDEPENDENT TRUST COMPANY?

Aren't partners in independent trust companies equipped to value their own business? Unlike many other closely held businesses, trust companies often have ownership groups with ample training in relevant areas of finance that enable them to understand financial statement analysis, cash flow forecasting, and market pricing data. What they lack is the arms' length perspective to use their technical skills to determine an unbiased result.

Many business owners suffer from familiarity bias and the so-called "endowment effect" of ascribing more value to their business than what it is actually worth simply because it is well-known to them or because it is worth more to them simply because it is already in their possession. On the opposite end of the spectrum, some owners prone to forecast extreme mean reversion such that they discount the outperformance of their business and anticipate only the worst. Partners with a strong grounding in securities analysis and portfolio management have a bias to seeing their business from the perspective of intrinsic value, which can limit their acceptance of certain market realities necessary to price the business at a given time.

In any event, just as physicians are cautioned not to self-medicate, and attorneys not to represent themselves, so too should professional investment advisors avoid trying to be their own appraiser.

## "Rules of Thumb" Don't Work

Many owners of independent trust companies consider the value of their practice using broad-brush metrics referred to as "rules-of-thumb." Such measures admittedly exist for a reason, but cannot begin to address the issues specific to a given firm.

Understanding why such rules-of-thumb exist is a good way to avoid being blindly dependent on them. Observed market multiples are often condensed into "rules of thumb", or general principals about what an investment firm is or should be worth. These rules provide a simple, back-of-the-envelope way of quickly computing an indicated value of a trust company. However, rules of thumb are not one-size-fits-all.

As an example of this, industry participants might consider trust companies as being worth some percentage of AUA. At one time, valuations were thought to gravitate toward about 2% of AUA. The example below demonstrates the problematic nature of this particular rule of thumb for two independent trust companies of similar size, but widely divergent fee structures and profit margins.

|                                     | Firm A              | Firm B              |
|-------------------------------------|---------------------|---------------------|
| Assets Under Administration         | \$1,000,000,000     | \$1,000,000,000     |
| x Realized Average Fee              | 1.00%               | 0.40%               |
| = Revenue                           | \$10,000,000        | \$4,000,000         |
| x EBITDA Margin                     | 25.00%              | 10.00%              |
| = EBITDA                            | \$2,500,000         | \$400,000           |
| <b>Implied value at 2% of AUA</b>   | <b>\$20,000,000</b> | <b>\$20,000,000</b> |
| <b>Effective Multiple of EBITDA</b> | <b>8.0x</b>         | <b>50.0x</b>        |

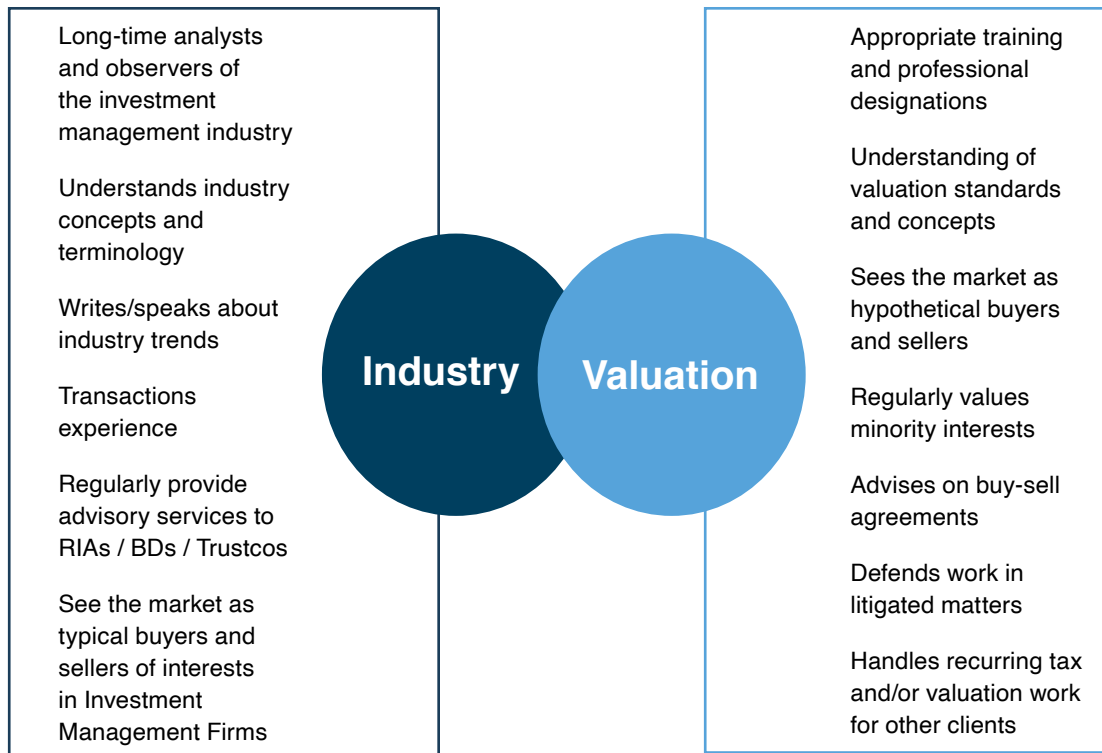
Both Firm A and Firm B have the same AUA. However, Firm A has a higher realized fee than Firm B (100 bps vs 40 bps) and also operates more efficiently (25% EBITDA margin vs 10% EBITDA margin). The result is that Firm A generates \$2.5 million in EBITDA versus Firm B's \$400 thousand despite both firms having the same AUA. The "2% of AUA" rule of thumb implies an EBITDA multiple of 8.0x for Firm A—a multiple that may or may not be reasonable for Firm A given current market conditions and Firm A's risk and growth profile, but which is nevertheless within the historical range of what might be considered reasonable. The same "2% of AUA" rule of thumb applied to Firm B implies an EBITDA multiple of 50.0x—a multiple which is unlikely to be considered reasonable in any market conditions.

We've seen rules of thumb like the one above appear in buy/sell agreements and operating agreements as methods for determining the price for future transactions among shareholders or between shareholders and the company. The issue, of course, is that rules of thumb—even if they made perfect sense at the time the document was drafted—do not have a long shelf life. If value is a function of company performance and market pricing, then both of those factors have to remain static for any rule-of-thumb to remain appropriate. This circumstance, obviously, is highly unlikely.

## Choosing An Independent Expert

Once you decide to engage a professional to value your firm, you'll need reasonable criteria to decide whom to work with.

Choosing someone to perform a valuation of your independent trust company can be daunting in and of itself. Over time, we have reviewed a wide variety of work product from different types of service providers - but have generally observed that there are two types of experts available to the ownership of independent trust companies: Valuation Experts and Industry Experts. These two types of experts are often seen as mutually exclusive, but you're better off not hiring one to the exclusion of the other.



There are plenty of valuation experts who have the appropriate training and professional designations, understand the valuation standards and concepts, and see the market in a hypothetical buyer-seller framework. And there are a number of industry experts who are long-time observers and analysts of the industry, who understand industry trends, and have experience providing advisory services to independent trust companies. However, business valuation practitioners are often guilty of shoehorning investment management business into their generic business valuation templates, resulting in flawed valuation conclusions that don't square with market realities. By contrast, industry experts are frequently guilty of a lack of awareness concerning the use and verification of unreported market data, for the misapplication of valuation models, and for not understanding the reporting requirements of valuation practice.

At Mercer Capital, we think it is most beneficial to be both industry specialists and valuation specialists.

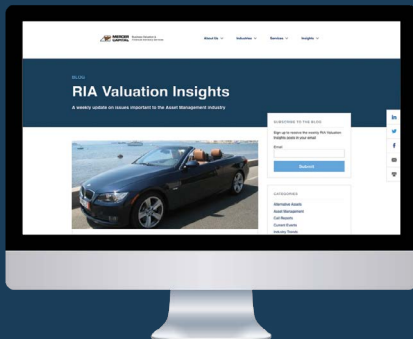
The valuation profession is still, for the most part, populated with generalists. But as the profession matures, an increasing number of analysts are realizing that it isn't possible to be good at everything, and that they can do better work for clients if they specialize in a type of valuation or a particular industry. Because our firm has had a specialty in valuing financials since they day we opened for business in 1982, it was easy to pursue this to its logical conclusion.

***Do you need an objective, independent opinion from someone with experience valuing independent trust companies?***



# RIA Valuation Insights Blog

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# HOW YOUR APPRAISER WILL “SCOPE” VALUING YOUR FIRM

Before covering specific approaches to valuation, there are a few basic valuation concepts that must be explored. Some business owners may be surprised to learn that their business does not have a single value, but rather, that its valuation is determined by numerous factors. Tax, legal, and other elements play important roles in defining value based upon the transfer circumstances. While there are significant nuances to each of the following topics, our purpose is to help you combine the economics of valuation within the relevant framework.

## The Valuation Date

Every valuation has an “as of” date, which is the date on which the analysis is focused. The date may be set by legal requirements related to a death or divorce, or it may be implicit, such as the closing date of a transaction. In many circumstances, a valuation must consider only what was “known or reasonably knowable” at the valuation date.

## Purpose

The purpose of the valuation is linked to the transfer event at hand (such as a sale, estate planning, or buy-sell agreement trigger). A valuation prepared for one purpose is not necessarily useful or applicable for another.

## Standards of Value

The standard of value is an important legal concept that must be addressed in every valuation assignment, as it influences the selection of valuation methods as well as the level of value. “Fair market value,” most commonly used in tax matters, is the most familiar standard of value. Other important standards of value include “investment value” (purchase and sale transactions), “fair value” (financial reporting purposes under GAAP), “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 for the intended purpose.

### Fair Market Value

Fair market value is defined as follows:

*The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. (American Society of Appraisers Business Valuation Standards)*



The willing seller and the willing buyer are hypothetical parties. Each is assumed to be well informed about the subject interest and the market context in which it might be transacted.

Fair market value is the most commonly used standard of value in business appraisals. With respect to the trust administration industry and business valuation, the development and communication of “fair market value” requires an awareness of the market conditions under which trust companies typically transact and the general conditions that transfers of ownership interests are subject to.

### **Investment Value (Strategic Value)**

Investment value is defined as follows:

*The value to a specific investor based on their particular investment requirements and opportunities. The value produced would reflect the knowledge, expectations, synergies, and economies of scale of the particular investor. (American Society of Appraisers Business Valuation Standards)*

Investment value, also referred to as “strategic value” or “value to the owner,” is often used when valuation or investment banking professionals are advising their clients on the merits of executing a specific transaction such as buying or selling a specific business or asset. Investment value answers the question – what is a trust company worth to a specific party based on investor-specific considerations?

Strategic value is often higher than fair market value. Consider the following.

In the context of a hypothetical buyer and hypothetical seller framework, the value of an independent trust company is likely based on the present value of expected future cash flows generated by the business with some consideration for market pricing. The value may consider foreseeable strategic initiatives such as increased spending on technology aimed to improve customer experience and relationships. However, the value of the business is generally thought to be the same to any financial investor in the business.

Compare this situation to the circumstance of one trust company buying another trust company in order to expand its geographic presence, reduce overhead, and combat margin compression. This buyer may pay more for every \$1 under administration at the target company with the expectation that it can reduce the company’s current expense base and earn higher margins. The strategic value in this case could be much higher than fair market value, based on selling the business to another trust company, which is motivated beyond the objectives and purely financial motivations of a hypothetical investor.

It may be reasonable to assume that an eventual strategic exit value could be available to any owner with the capacity and patience to wait for it. That is not to say that when a strategic exit is planned (or reasonable to expect) that the two values will converge. If such an exit is five, ten, or more years in the future, there can be a meaningful difference between fair market value and investment/strategic value. The complexity of these considerations may be compounded when valuing minority interest positions in a business versus a controlling interest.

## Fair Value in Legal Matters

In legal matters, fair value is a statutory standard of value (inclusive of any relevant judicial guidance) applicable to cases involving dissenting or oppressed shareholders and/or with respect to corporate reorganizations or recapitalizations. Fair value may also have a specific and differentiated meaning for divorce under the laws of each state. In litigation proceedings, case venue and jurisdiction dictate.

Fair value frameworks will typically reconcile to a single or hybrid definition of value under the standard of fair market value or investment value. Legal counsel determines the value-defining elements as part of the engagement agreement with the valuation expert.

## Fair Value for Financial Reporting Purposes

The Financial Accounting Standards Board (FASB) functionally introduced the discipline of fair value measurement for accounting purposes with a series of pronouncements dating to the early 2000s. The changes were intended to impart greater financial transparency and consistency in an accounting universe steeped in historical cost disciplines and to enhance the accuracy and timeliness of information provided to users of financial statements whether they be lending institutions, investors in publicly traded securities, or individual owners of closely held businesses.

We will not delve into the details; however, it's important for trust companies to understand how fair value is applied upon the closing of a transaction and during annual goodwill impairment tests.

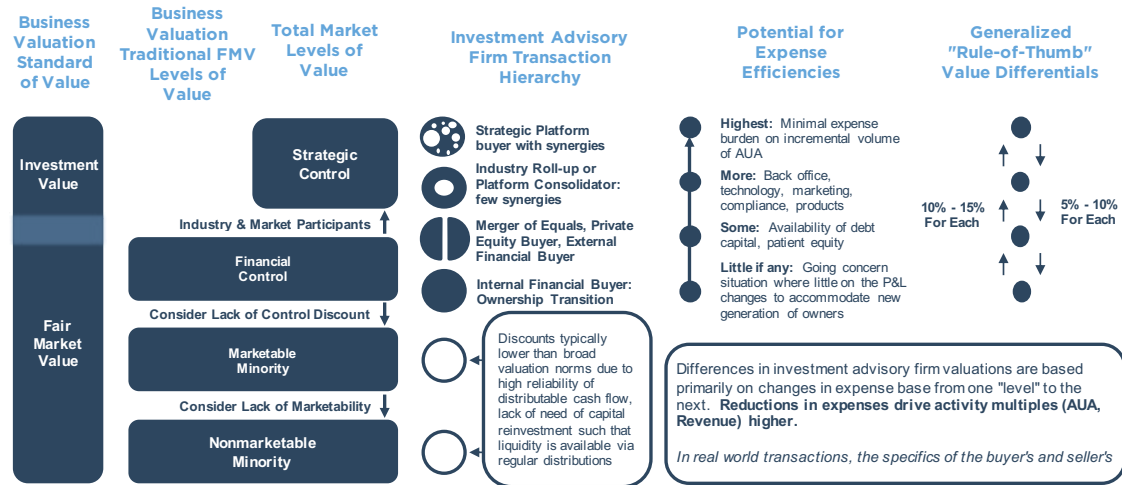
When the acquisition of a trust company occurs, the aggregate value paid for the company's assets is required to be allocated to the various assets purchased. For companies that develop their financial statements under GAAP, this specific exercise (called a purchase price allocation) is required to allocate the total enterprise value to the acquired assets, both tangible and intangible. For trust companies that have very few tangible assets, a purchase price allocation is even more important so that the balance of intangible assets can be allocated to amortizable intangibles such as the value of the customer relationships and non-amortizable assets such as goodwill.

Not only are PPAs vital to the process of purchase accounting, so too is the annual or periodic test for impairment. If your financial statements include a significant intangible asset balance and there is an unfavorable change in the market value for such assets, your accountant may require an impairment test. An impairment test includes an analysis to determine if a previously recorded asset value is impaired. If impairment is indicated, an additional analysis quantifies the adjusted value and the corresponding impairment charge required to restate the value of the asset.

## Levels of Value

When business owners think about the value of their business, they often neglect to consider the levels of value concept. 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 may not be appropriate if the aggregate block of stock does not have control of the enterprise; in many cases, the value of a single share will be less than its pro rata share of the enterprise.

The determination of whether the valuation should be on a controlling interest or minority interest basis can be a complex process, but it is also essential. 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 from which the value of a business interest is developed.



## VALUATION METHODOLOGY

There are three general approaches to determining the value of a business—the asset-based approach, the income approach, and the market approach. The three approaches refer to different bases upon which value may be measured, each of which may be relevant to determining the final value. Ultimately, the concluded valuation will reflect consideration of one or more of these approaches (and perhaps several underlying methods) based on those most indicative of value for the subject interest. The table below summarizes the methods typically used to value trust companies under each valuation approach.

| Asset Approach   | Income Approach   | Market Approach  |
|--|---|--|
| Generally not applicable because trust companies are not (internally) capital intensive businesses | Discounted cash flow analysis to evaluate business plan and industry trends | Pricing metrics from public companies and transactions relative to company performance characteristics |

## Asset Approach

The net asset value method is, in simple terms, a balance sheet approach to value. Book value (or adjusted book value, sometimes called net asset value) is a primary benchmark of value in many asset intensive companies but typically provides little insight into the value of trust companies, which usually don't have a significant balance sheet or tangible capital base.

## Market Approach

The market approach is a general way of determining the value of a business which utilizes observed market multiples applied to the subject company's performance metrics to determine an indication of value. The "market" in market approach can refer to either public or private markets, and in some cases the market for the subject company's own stock if there have been prior arms' length transactions. The idea behind the market approach is simple: similar assets should trade at similar multiples (the caveat being that determining what is similar is often not so simple). The market approach is often informative when determining the value of a trust company.

There are generally three methods that fall under the market approach.

1. Guideline Public Company Method
2. Guideline Transaction Method
3. Internal Transaction Method

All three methods under the market approach involve compiling multiples observed from either publicly traded guideline companies, comparable transactions in private companies, or prior transactions in the company's own stock and applying the selected (and possibly adjusted) market multiples to the company's performance measures.

### Multiple Multiples

The most common multiples used when valuing trust companies are enterprise value (EV) to EBITDA<sup>1</sup>, EV to AUA, and EV to revenue multiples. The multiples used are generally categorized as either "activity" multiples or "profitability" multiples. Activity multiples are multiples of AUA and revenue whereas profitability multiples are multiples of earnings metrics (e.g. EBITDA).

Both profitability and activity multiples have their advantages and disadvantages. Activity multiples can provide indications of value for a subject trust company that are only a function of the chosen activity metric—typically AUA or revenue. Such an indication is not a function of the profitability of the firm, which can be an issue because the underlying profitability of a firm is the ultimate source of value, not revenue or AUA. The benefit of activity metrics, however, is that they can be used without explicitly making normalizing adjustments to a trust company's profitability. The caveat, however, is that applying market-based AUM and revenue multiples to the subject company's activity metrics is essentially transposing the realized fee structures and EBITDA margins of the guideline companies onto the subject firm—an implicit assumption about normalized profitability and realized fees which may or may not be reasonable depending on the specific circumstances.

<sup>1</sup> Trust companies typically have little "DA", so EBITDA is typically approximately equal to EBIT and operating income.

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. In the alternative case, some companies achieve sustainably higher-than-normal margins, which justify correspondingly higher valuations. However, 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 is only indirectly related to the level of business activity.

Profitability multiples, on the other hand, explicitly take into account the subject firm's profitability, which on its face is a good thing. Profitability metrics are not without their drawbacks, however. Differences in risk or growth characteristics will, all else equal, result in different EBITDA multiples. If the risk or growth prospects of the subject company differ from the guideline companies that informed the selected EBITDA multiple, then the appropriate multiple for the subject company will likely differ from the observed market multiple.

### **Subject Company Performance Measures**

Once a market-based profitability multiple is obtained which reflects the risk and growth prospects of the subject firm, the next question is often: which EBITDA (or other profitability metric) is the multiple applied to? Reported EBITDA? Management adjusted EBITDA? Analyst adjusted EBITDA? Independent trust companies frequently require significant income statement adjustments—the largest of which is typically related to normalizing compensation—and so the answer to the question of which EBITDA to apply the multiple to can have a significant impact on the indicated value.

It's often said that "value equals earnings times a multiple." While there is some truth to be had there, the simplicity of the statement belies the reality that the question of the appropriate multiple and the appropriate measure of earnings is rarely straightforward, and buyers and sellers may have very different opinions on the answer.

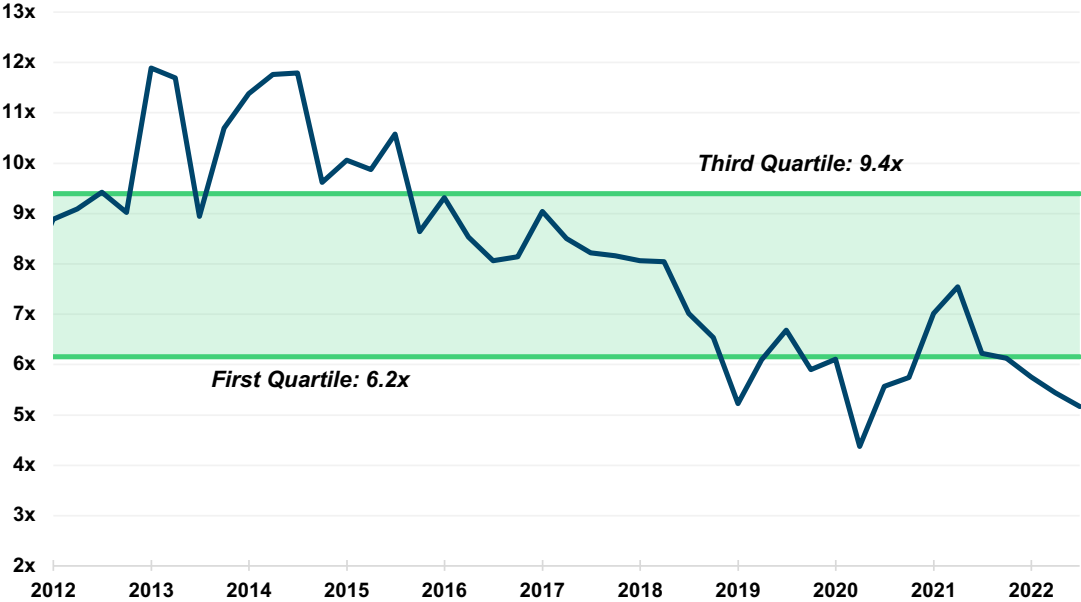
### **Guideline Public Company Method**

The guideline public company method uses multiples obtained from publicly traded businesses to inform the value of a subject company. While there are no publicly traded pure-play trust companies, there are several publicly traded asset and wealth management firms that have similar revenue drivers and cost structures as independent trust companies. As such, these businesses offer some insight into the valuation of trust companies.

The chart on the next page shows historical EV / LTM EBITDA multiples for publicly traded asset and wealth management firms with less than \$100 billion in AUM (the size range which most of our clients fall in). As shown in the chart, these companies have generally traded in a band of 6-9.5x LTM EBITDA. Since 2018, EBITDA multiples for smaller publicly traded asset/wealth managers have largely remained below historical norms. This downturn reflects adverse trends like pricing pressure and asset outflows that have impacted this group of public companies.

Multiples observed in the public markets provide perspective, but there are factors that drive pricing differentials between public/private companies. Independent trust companies, along with many sectors of closely-held RIAs and larger public asset/wealth managers, have been less impacted by the trends affecting the smaller publicly traded asset managers and have seen more resilient multiples as a result. In the case of wealth management firms, strong demand from aggregators has also helped to bolster pricing in recent years.

**EV / EBITDA Multiples for Publicly Traded RIAs under \$100B AUM  
(2012 - 2022)**



Despite the less-than-perfect comparability between publicly traded companies and most privately held trust companies, publicly traded companies provide a useful indication of investor sentiment for a similar asset class and thus should be given at least some consideration. However, due to differences in risk profile, growth characteristics, and industry dynamics, adjustments to the multiples observed in the guideline companies may need to be made.

**Guideline Transactions Method**

Guideline transactions of private companies in the trust company space provide additional perspective on current market pricing. The data underlying the guideline transaction method is based on publicly available deal terms and financial metrics from various databases, regulatory filings, and disclosures which we accumulate and maintain as the information becomes available. Often, publicly disclosed transactions include little detail about the underlying performance metrics that contributed to the pricing negotiated, but we nonetheless gather what information we can find.

The transaction data is appealing because the issues of comparability are generally less pronounced than with the guideline public companies. There are caveats to the guideline transactions method, however. One unique consideration for the use of the guideline transactions method in the industry is

that deals frequently include some form of contingent consideration (or earn-out). The structure of such contingent consideration will be tailored to each deal based on the specific concerns and negotiations of the buyers and sellers. In any event, the details of the earn out payments are often not publicly available. The lack of available information on deal terms can make it difficult to determine the actual value of the consideration paid, which translates into uncertainty in the guideline transaction multiples.

Another important consideration is that deals in the industry occur for unique reasons and often involve unique synergies. It is not always reported what these are, and the specific factors that motivated a particular guideline transaction may not be relevant for the subject company. The type of buyer in a guideline transaction is another consideration. Private equity (financial buyers) will have different motivations and will be willing to pay a different multiple than strategic buyers.

Despite an uptick in sector deal activity over the last several years, there are still relatively few reported transactions that have enough disclosed detail to provide useful guideline transactions multiples. Looking at older transactions increases sample size, but it also adds transactions that occurred under different market conditions, corporate tax environments, and the like. Stale transaction data may not be relevant in today's market.

Despite the limitations, guideline transactions do represent real world industry pricing and at least serve to provide perspective about the value of businesses that are in some way relevant to the subject company.

### **Internal Transaction Method**

The internal transactions method is a market approach that develops an indication of value based upon consideration of actual transactions in the stock of a subject company. Transactions are reviewed to determine if they have occurred at arms' length, with a reasonable degree of frequency, and within a reasonable period of time relative to the valuation date. Inferences about current value can sometimes be drawn, even if there is only a limited market for the shares and relatively few transactions occur.

However, even arms' length transactions in the subject company stock occur for unique reasons and often involve unique synergies, which means even these implied multiples are not always a clean indicator of value.

## **The Income Approach**

The income approach is a general way of determining the value of a business by converting anticipated economic benefits into a present single amount. Simply put, the value of a business is directly related to the present value of all future cash flows that the business is reasonably expected to produce. The income approach requires estimates of future cash flows and an appropriate discount rate with which to determine the present value of future cash flows.

Methods under the income approach are varied but typically fall into one of two categories:

1. Single period capitalization of free cash flow
2. Discounted future cash flow model (DCF)

### Single Period Capitalization Model

The simplest method used under the income approach is a single period capitalization model. Ultimately, this method is an algebraic simplification of its more detailed DCF counterpart. As opposed to a detailed projection of future cash flow, a base level of annual net cash flow and a sustainable growth rate are determined.

$$\boxed{\text{Value of a Business}} = \frac{CF_0(1+g)^1}{(1+r)^1} + \frac{CF_0(1+g)^2}{(1+r)^2} + \dots + \frac{CF_0(1+g)^\infty}{(1+r)^\infty} = \boxed{\frac{CF_0(1+g)}{(r-g)}}$$

The denominator of the expression on the right ( $r - g$ ) is referred to as the “capitalization rate”: and its reciprocal is the familiar “multiple” that is applicable to next year’s expected cash flow. The multiple (and thus the firm’s value) is negatively correlated to risk and positively correlated to expected growth.

There are two primary methods for determining an appropriate capitalization rate – a public guideline company analysis or a “build-up” analysis. The most familiar method applies the P/E ratio from a guideline public company analysis. A build up analysis can be based up on the Capital Asset Pricing Model (CAPM) or Adjusted CAPM (ACAPM). Both the P/E ratio and the built-up capitalization factor articulate the risk and growth factors that investors believe underlie earnings measures.

### Discounted Cash Flow Model

Independent trust companies are frequently valued using the DCF method because this method allows for detailed modeling of revenue and expense items over the discrete projection period. A discrete projection period of three to five years is typically employed so that AUA trends, fee levels, and operating expenses can be modeled with reasonable certainty based on the current trends and business model. Beyond the discrete projection period, it is assumed that the business will grow at a constant rate into perpetuity. In circumstances where no changes in the business model or capital structure are expected, a single period capitalization method may suffice.

The discounted cash flow methodology requires three basic elements:

1. Forecast of expected future cash flows
2. Determination of terminal value
3. Selection of an appropriate discount rate



## Forecast of Expected Future Cash Flows

Both the single period capitalization model and DCF model require a base level of cash flows to either (1) capitalize with the appropriate multiple, or (2) use as starting point to model future growth and profitability.

The base rate of profitability is determined by a trust company's current revenue and cost structure, with possible adjustments made. It is often said that trust companies generate revenue while they sleep, as revenue is a function of AUA and is typically not commission based. The fee-based revenue model used by most trust companies allows us to determine an ongoing (run rate) level of revenue by multiplying AUA at any given day by the average realized fee structure.

The base rate of expenses for independent trust companies is typically based on reported expenses over the most recent annual period, with adjustments made for various items (the most significant of which typically relates to normalizing compensation).

## Projected Cash Flow

We typically view the discounted cash flow method as superior to the single period capitalization approach as it is more dynamic and allows for the discrete forecasting of cash flows. Projections of future cash flows rely on many assumptions as explained below.

| Projected Distributable Cash Flow                                     |   |
|---|---|
| <b>Average AUA</b>  | Revenue Mix, Capture & Loss Rate, Marketing Effectiveness                           |
| <b>x Realized Fees</b>  | Fees schedule trends in light of competitive pressure                               |
| <b>= Revenue</b>  | Include any non fee-based sources of revenue  |
| <b>- Owner Compensation</b>   | Salary, bonus, & benefits   |
| <b>- Staff Compensation</b>   | Appropriate staffing for business plan; wage pressure for key relationship managers |
| <b>- Non-Personnel Costs</b>  | Non-labor cost trends; can be source of operating leverage                          |
| <b>= Pre-Tax Profitability</b>  | Evaluate in light of industry norms and trends                                      |
| <b>+/- Noise (CapEx, Depreciation, Investment in Working Capital)</b> | Rarely significant  |
| <b>- Taxes</b>  | State or federal taxes or tax pass-through  |
| <b>= Distributable Cash Flow</b>                                      | Source of incentive compensation or real profitability?                             |

## Assets Under Administration

Projected AUA growth should consider both growth in net new business and expected market returns based on overall asset allocation. When determining growth in AUA it is important to ask what has historically driven growth and if it is reasonable to assume that this trend will continue. For example, has

a firm's historical AUA growth been driven by market movement or by new client generation? Markets will have good years and bad years, but strong client relationships (and the ability to generate new ones) result in a continual source of new assets to manage. **Client assets do correlate to a great extent with the market, but client relationships do not.** Without proper relationship management, assets leave and revenue suffers.

## Realized Fees

Projected realized fees are typically evaluated in light of historical levels. Trust company fees have generally withstood fee pressure seen in the broader investment management industry.

## Compensation

Trust administration is a people-intensive business that requires the time and energy of a dedicated staff. The majority of a typical trust company's expenses are personnel expenses, which include salaries, bonuses, and other benefits for employees and officers. Compensation generally tracks revenue fairly closely, making operating leverage more pronounced with overhead costs than compensation related expenses.

Compensation programs tend to evolve over time and take on a life of their own. Inevitably, compensation programs tend to be intertwined with the business model and ownership. The valuation process typically includes an analysis of the compensation program to formulate a normalized margin that can be used to value the firm.

The compensation structure for owners is often affected by the tax environment. The corporate structure of a firm (C Corp vs S Corp or other pass-through entity) as well as the current federal and state tax environment frequently determines whether firms pay out profit as bonuses or distributions. For example, in states with high corporate tax rates but no personal income tax, cash flow is more likely to be paid out in the form of bonus compensation rather than distributions in order to reduce taxable income at the corporate level.

## Non-Compensation Operating Expenses

Marketing expenditures have increased as trust companies seek to attract new clients. Additionally, spending on technology has increased as trust companies seek to automate certain administrative tasks and allow fewer trust officers to manage more assets.

With some exceptions, trust companies' non-compensation operating expenses are fixed in nature, which allows trust companies to take advantage of operating leverage over time.

## Terminal Value & Discount Rate

At the end of the discrete projection period, the remaining cash flows are capitalized and represented by a terminal value. An appropriate discount rate is used to discount the forecasted cash flows and the terminal value to the present.

The sum of the present values of all the forecasted cash flows (both the discretely forecasted periods and the terminal value) is the indication of value for a specific set of forecast assumptions.

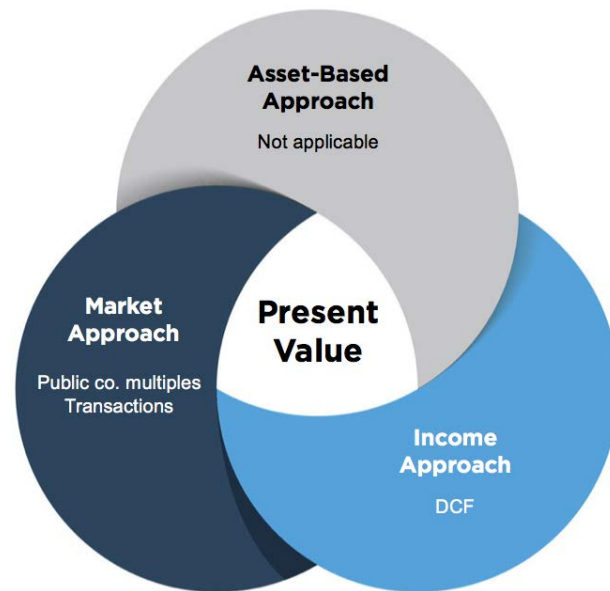
## RECONCILING INDICATED VALUES

Your firm's valuation should clearly articulate the observations, assumptions, adjustments, and empirical data upon which methods are based. If your valuation provider cannot develop and report their analyses in a manner that you sufficiently understand, get clarification or a new appraiser. You may not agree 100% with the conclusion, but you should understand the methods used and recognize your trust company in the report.

Additionally, your firm's valuation should make sense in light of industry trends and valuations observed within the public and private markets.

It would be unusual for the indicated values from the various income and market methods to align perfectly.

The asset approach is generally not relevant to the valuation of trust companies. However, the balance sheet can be remarkable in situations where there are excess or non-operating assets or contingent liabilities that need to be considered apart from the value of the firm's ongoing operations.



Value indications from the market approach can be reasonably volatile, since the market for trust companies is leveraged to the performance of the market in general. Because valuation for fair market value purposes is more of a descriptive exercise than a prescriptive one, this is a perspective we consider.

In our experience, though, investors in private companies think longer term. The more enduring indications of value from income approaches such as DCF models are often more representative of the actual behavior of real-world buyers and sellers of interests in trust companies. Nonetheless, using multiple valuation approaches serves to generate tests of reasonableness against which the different indications can be evaluated.

## PUTTING IT ALL TOGETHER

Although some view the industry as mature, the industry has changed significantly over the last decade. The shift towards the independent trust company and directed trustee model has helped align the interests of trust company ownership with that of their clients. Separation from bank ownership and the asset management function has allowed independent trust companies to increase their focus on the specific trust administration issues that impact their clients. More time is being spent addressing the actual needs of clients, as technological advancements have freed up time and improved service offerings. This new model benefits both the client and the advisor, which is evidenced by the growing AUA in the space.

Amidst this, the industry is consolidating as some owners look to increase scale and improve operating leverage, and others look for a retirement plan or exit. Understanding value today, as well as planning for tomorrow's value driven events is essential in this changing landscape. The value of an independent trust company is very much about context. We hope this white paper has increased your understanding of the considerations and key factors that impact the valuations of independent trust companies.

## About Mercer Capital

**Mercer Capital provides investment managers, wealth managers, independent trust companies, and financial institutions with business valuation and financial advisory services related to corporate disputes, litigated matters, 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:

- Valuing start up managers with as little as \$50 million in assets under management to established industry leaders managing over \$400 billion
- Negotiating transactions 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
- Providing expert witness testimony for purposes of marital dissolution and shareholder disputes
- Assisting RIAs and other asset managers with annual ESOP valuations, fairness opinions, and appraisals for gift and estate tax compliance

Mercer Capital's Investment Management industry group publishes research on the industry via its quarterly newsletter, *Value Focus: The Investment Management Industry*. The Group also writes about issues important to the industry on the *RIA Valuation Insights* blog.

## Mercer Capital's Investment Management Team



**Matthew R. Crow, ASA, CFA**  
crowm@mercercapital.com  
901.685.2120



**Brooks K. Hamner, CFA, ASA**  
hamnerb@mercercapital.com  
901.322.9714



**Jeff K. Davis, CFA**  
jeffdavis@mercercapital.com  
615.345.0350



**Daniel P. McLeod, CFA**  
mcleodd@mercercapital.com  
901.322.9716



**Zachary W. Milam, CFA**  
milamz@mercercapital.com  
901.322.9705



# Mercer Capital

1.800.769.0967

[www.mercercapital.com](http://www.mercercapital.com)