Alternative Asset Custody Services
Positive Dynamics Power Growth

The alternative asset custody services sector is an attractive industry for both private equity investment and strategic buyers (commercial banks and other financial services firms). Favorable industry dynamics, high-value revenue streams and compelling economics are characteristics that appeal to a broad range of potential buyers. There are a number of alternative asset custodians owned by entrepreneurs that are reaching retirement age and have no obvious successors. We expect to see a significant increase in acquisition activity in the alternative asset custodial services industry.

Alternative asset custody services firms have many attractive attributes:

- **Positive operating environment:** A well-managed alternative asset custodian will take advantage of the major themes that are generating growth in the sector:
  - Outsourcing of alternative asset custodial services by major securities firms and global asset custodians
  - Rollover IRA opportunities with major sponsors of defined contributions plans
  - Need for qualified custodians for the new alternative assets RIAs created by Dodd-Frank
  - Opportunities in new markets such as peer-to-peer lending and equity crowdsourcing
- **Recurring revenues:** A strong alternative asset custodian becomes operationally entangled with its clients, providing sophisticated and complicated administrative services that have a significant technology component. This creates sticky client relationships and a recurring revenue stream.
- **Compelling industry economics:** Margins in the industry are high, and capital requirements are modest. Unlike the registered investment advisor sector, an alternative asset custodian is not dependent on investment performance for success, and the business is not tied to a few key individuals setting investment strategies. The successful alternative asset custodian has a platform that is driven by systems and volume; the operating leverage in the business is significant.

Alternative asset custody services is a significant segment of the massive global custody services industry. Global custodians provide securities safekeeping services and asset-servicing functions primarily to institutional investors worldwide. The global custody services industry is dominated by large institutions that compete ferociously for large customers. The top four global asset custodians reported assets under custody ("AUC") of $79 trillion at December 31, 2013; industry sources expect those four institutions to report AUC of $85 trillion at December 31, 2014, an increase of 5%. Alternative asset custody services providers operate in a segment that is much smaller but dynamic and growing. The specialized services provided by these alternative asset custodians are less subject to price competition than the standard services offered by global custodians.

- Custodians of alternative assets – investments other than traditional stocks, bonds and cash – enjoy high-value revenue streams, high growth, operating leverage and low levels of capital intensity. Some of these firms are subject to cyclical earnings based on interest rate levels and are poised to benefit from a rising interest rate environment. Custodians of all stripes require significant on-going system development risks and expense.

- In the past, alternative asset investments were made primarily by institutional investors and high net worth individuals/families. This has changed over time as the mass affluent become aware of the diversification and return opportunities offered by alternatives. This "democratization" of alternative asset investments has increased individual investors' demand for alternative investments. Many investors are investing through self-directed individual retirement accounts; every self-directed IRA must have a qualified custodian.

- Alternative assets require customized safekeeping and servicing that do not fit with the standardized and automated processes of mega-custodians and securities firms. The difficulty of administering alternative assets increases costs and can decrease customer satisfaction at the large firms. This has led to a wave of outsourcing by large custody services providers to specialized alternative asset custodians.

- The Dodd-Frank Wall Street Reform and Consumer Protection Act and subsequent rules adopted by the SEC require registered investment advisers ("RIAs") that manage private funds to comply with the Investment Advisers Act. For most RIAs, this means that alternative assets must be held by a qualified custodian. The private equity industry is one sector impacted by the expanded application of the custody rule. These rules, combined with the effect of the Madoff scandal, have led to a sharp increase in demand from private equity managers and others for the services offered by specialized alternative asset custodians.

- In addition to the robust expansion of existing alternative asset markets, specialized alternative asset custodians have opportunities to administer new classes of alternative assets. The peer-to-peer lending sector (LendingClub and Prosper.com for consumer lending, SoFi for student loans, FundingCircle for small business lending, et al.) needs qualified custodians, especially in view of the recent influx of institutional capital into that sector. Crowdfunding is another emerging area that has begun to generate demand for alternative asset custodians, and crowdfunding web sites such as CircleUp, FundRise and I-Bankers Direct are generating assets that require administration by a qualified custodian.

- Some alternative asset custodians also offer a solution to the "left behind" accounts problem experienced by corporate sponsors of defined contribution retirement plans (401k plans, et al.). The Economic Growth and Tax Relief Reconciliation Act of 2001 authorized defined contribution plans to automatically distribute account funds to participants via rollover into an IRA. While this eliminates the requirement that defined contribution plan sponsors maintain and administer the small 401k accounts of former employees, these rollover IRAs require a qualified custodian. A number of alternative asset custodians offer a turnkey solution for the administration of these small dollar rollover IRAs.

- This virtuous circle of unmet needs and regulatory changes has created conditions for rapid growth in the alternative asset custodial services industry. Some participants in this industry are experiencing significant expansion of revenues and profits.

The participants in the alternative asset custodial services industry consist of independent trust companies and divisions of commercial banks. The pricing model for most firms is based on fees tied to the assets under administration (generally a sliding scale as AUA increases). Certain services are provided on a fixed-fee basis. In addition, providers of small account IRA rollover services may receive a share of the earnings generated by IRA rollover balances.

Democratization of alternative asset investments

Alternative investments consist of financial holdings of assets other than traditional stocks, bonds and cash. The major categories of alternative assets are hedge funds, private equity/private debt, commodities/futures, real estate, "peer-to-peer" loans/notes and miscellaneous other items (oil and gas partnership interests, farmland, etc.). Common reasons cited by investors for investing in alternative assets are desire for higher returns and portfolio diversification.

Individuals have increasingly used the self-directed IRA vehicle to invest in alternative assets; every self-directed IRA must be administered by a qualified custodian. The Investment Company Institute's most recent data reveals that total assets in IRA's exceeded $6.5 trillion in the fourth quarter of 2013. This pool represents a potentially significant source of investment capital for alternative investment managers and platforms. In addition, the Jump Start Our Business Startups Act (JOBS Act) of 2012 has made it possible for small to mid-sized companies to conduct a general solicitation for Regulation D private securities offering. Prior to the JOBS Act, Reg D private securities were available only to qualified institutional and accredited investors.

Large custodians are outsourcing alternative asset custody services to specialists

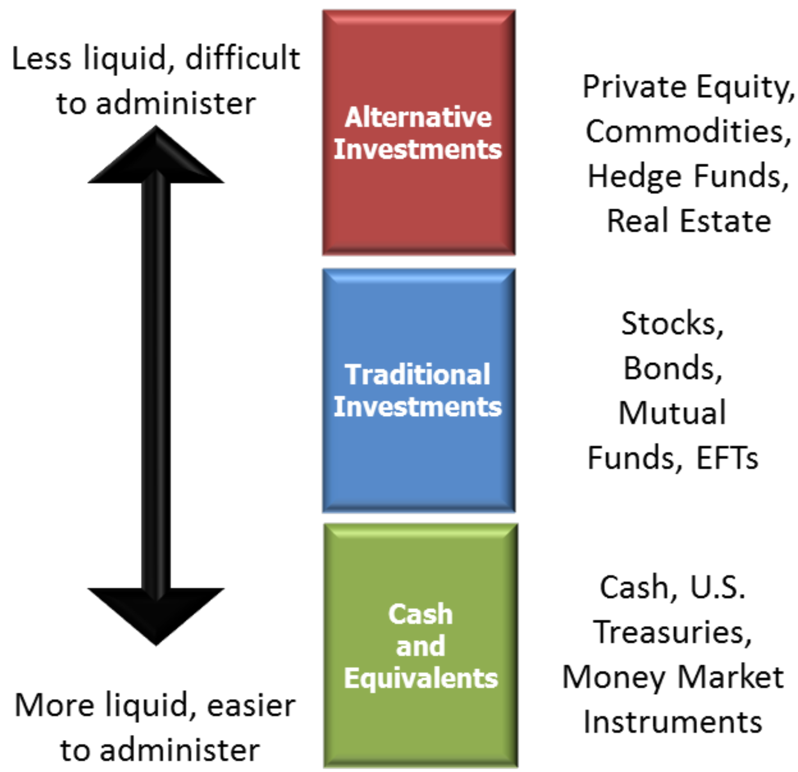
According to the Investment Company Institute, total net assets held by U.S. investment companies were about $17.1 trillion at the end of 2013. According to a study completed by the *Financial Times* and Towers Watson in 2013, about $1.4 trillion of alternative assets were managed by the top 100 managers in North America. According to industry sources, the top four global custodians had $79.4 trillion of AUC at the end of 2013; AUC grew to almost $85 trillion in 2014 according to Globalcustody.net.

Global Assets Under Custody (*$ in billions of USD*)

Rank	Provider	Total Global Assets
1	BNY Mellon	$28,300
2	J.P. Morgan	$21,000
3	State Street	$20,996
4	Citi	$14,700
5	BNP Paribas	$9,447
6	HSBC Securities Services	$6,210
7	Northern Trust	$5,910
8	Societe Generale	$4,915
9	Brown Brothers Harriman	$3,800
10	UBS AG	$3,438
11	SIX Securities Services	$3,247
12	CAEIS	$3,200

Source: globalcustody.net, 2015 (as of 9/14)
Note: data can involve double-counting due to sub-custody arrangements)

Providing custody services for alternative assets has historically been an administratively challenging activity. Many documents must be assembled and maintained; and alternatives have complex servicing requirements that differ across asset types. There is currently little in the way of standardization when it comes to custody of alternative assets.



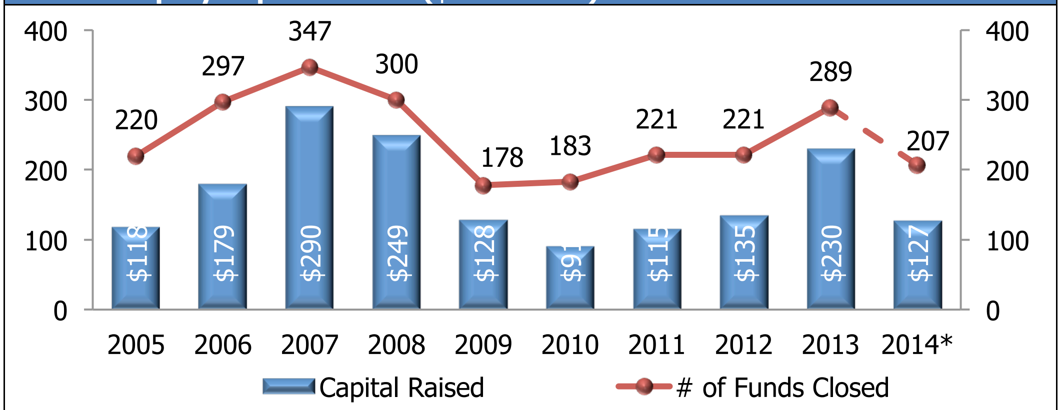
The custodial services required for alternative assets do not fit well with the automated, commodity processes applied by large custodians to cash, stocks and bonds. Since 2009, major custodians/clearing firms such as Charles Schwab, Fidelity, Pershing (sub of BNY-Mellon) and TD Ameritrade have contracted with specialized custodians to outsource the administration of alternative assets. This trend has led to a significant jump in revenues for providers of alternative asset custodial services. This trend towards outsourcing the administration of alternative assets is likely to continue and accelerate now that several major custodians have moved in this direction.

The need for qualified custodians has grown

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires that private fund advisors with more than $150 million in assets register as investment advisors with the SEC or relevant state agencies. The so-called "Custody Rule" (Rule 206(4)-2 under the Investment Advisers Act) now applies to this new group of RIA's, which means most of these firms will need to transfer custody of client assets to a qualified custodian. Due in part to the Madoff Ponzi scheme, the SEC revised and strengthened the Custody Rule. These changes provide a strong incentive for private fund managers to hire an independent custodian to meet the internal control and reporting standards required by the SEC's action on the Custody Rule.

The opportunity for alternative asset custodians presented by the Custody Rule change is substantial. There are at least 3,300 private equity firms headquartered in the United States, according to the Private Equity Growth Capital Council. Each private equity fund is a potential income opportunity for an alternative asset custodian. The following chart presents data regarding private equity fund-raising activity in the United States.

Private Equity Capital Raised ($ in billions) and # of Funds Closed



Source: PitchBook
**YTD 9/30/14*

An increase in investor awareness of and access to private equity funds is just one example of the need for qualified custodians to manage these alternative investments. In addition to private equity funds, there are private debt funds, real estate funds, infrastructure investment funds, hedge funds and venture capital funds that need qualified alternative asset custodians due to the changes brought about by Dodd-Frank reform and the Custody Rule.

New classes of alternative assets

The application of technology and web-enabled tools to private capital flows has created new categories of alternative assets that require sophisticated administration. While these new pools of alternative assets are still fairly small, they are growing rapidly. Some of the emerging companies in this new industry have turned to alternative asset management custodians to manage payments, documentation, financial reporting and tax reporting. The following chart summarizes three segments of this new landscape.

Online Platforms And Portals	Peer-to-Peer Lending	Social Finance Communities
Platforms that aggregate private investments with services (research, etc.)	Online lending that provides alternative to the traditional banking sector	Connects similar or mutually interested constituents via a dedicated investment portal
Connects issuers, investors (institutional and individual) and advisors	Loans funded by institutional and accredited individual investors	One party provides funding, The other party receives capital and connections
Examples: crowdfunding platforms (Fundable, Crowdfunder), turnkey alternative asset platforms (ClearVest, FNEX, ACE Portal)	Examples: consumer lending (Prosper.com, Lending Club) small business finance (OnDeck Capital, Funding Circle, Kabbage)	Examples: alumni funding platforms for college students (Prodigy, Pave, Sofi), social network lending – churches, interest groups, etc. (ZimpleMoney)

Peer-to-peer lending in the United States has been growing at a torrid rate. The largest peer-to-peer lender is LendingClub Corp; this firm grew loan volume from $718 million in 2012 to over $3 billion in the first nine months of 2014. In the second quarter of 2014, the two top peer-to-peer lenders in the U.S. (LendingClub and Prosper) originated $1.4 billion of loans. Both LendingClub and OnDeck Capital, a business lender, completed their initial public offerings in December 2014. OnDeck has also experienced rapid volume growth – loan originations were $459 million in 2013 and reached $788 million in the first nine months of 2014. Peer-to-peer lending is an industry largely funded by family offices, hedge funds and other large institutional investors; individuals are supplying small amounts of capital to the sector. These institutions demand excellent administration and custodial services. Peer-to-peer lenders require specialized administrative and servicing capabilities; alternative asset custodians can provide the necessary support.

Crowdfunding is also growing rapidly, fueled in part by the Jumpstart Our Business Startups Act (JOBS Act) signed into law by President Obama on April 4, 2012. Title II of the legislation was particularly important to the equity crowdfunding industry since it lifted the ban on general investment solicitations. This allows broader advertising and marketing of opportunities to accredited investors. The SEC approved the lifting of the ban on general solicitation on July 10, 2013. Total equity crowdfunding, which reached $2.7 billion in 2012 according to the Crowdfunding Industry Report by Massolution, is expected reach $10 billion in 2014. This jump is driven by the proliferation of crowdfunding portals, ease of use and the JOBS Act. According to the Crowdfunding Research Program at UC Berkeley, the securities crowdfunding market will range from $4 billion to as much as $300 billion annually over the coming years, depending on the development of regulations governing the activity.

The IRA rollover opportunity

Sponsors of defined contribution (DC) retirement plans such as 401k's have faced a growing problem. Ex-employees still belong to the plan but become classified as missing/non-responsive because they cannot be located by the employer or never acknowledge communications regarding the DC plan post-employment. This is expensive and can cause regulatory issues for plan sponsors due to the requirements of regular attempts to reach plan participants, accounting/reporting requirements for each participant account and distributions to plan participants. There are billions of dollars of uncashed distribution checks that were sent to DC plan participants. Improper handling of these uncashed checks by the plan sponsor can lead to fines or lawsuits. The problem of "left behind" DC plan accounts is likely to grow – participation rates in DC plans have hit 88% according to the Profit Sharing Council of America and about 9.5 million Americans change jobs each year.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRTA) addressed the "missing persons" problem. The legislation created a safe harbor for plan sponsors allowing automatic rollover of small balance retirement accounts into IRAs. Very small balances (under $1,000) can be cashed out by the sponsor. Accounts of $1,000 to $5,000 can rolled into an IRA administered by a custodian, subject to the Department of Labor's safe harbor provisions. Once the funds are transferred into a qualifying IRA, plan sponsors are not required to monitor the IRA custodian and have no responsibility for the custodian's compliance with laws and regulations.

Defined contribution plan sponsors have embraced the IRA rollover safe harbor option, creating a profitable and growing business for specialized custodians. The Department of Labor safe harbor provisions require that the custodian must be a qualified state or federally-regulated financial institution and that the funds in the rollover IRAs must be invested in an instrument that minimizes risk, preserves principal and provides a reasonable rate of return. The IRA custodians generally place the rollover IRA funds in federally-insured commercial bank deposits. The custodian receives fees for managing the rollover IRA account and generally receives a portion of the interest generated on the bank deposits.

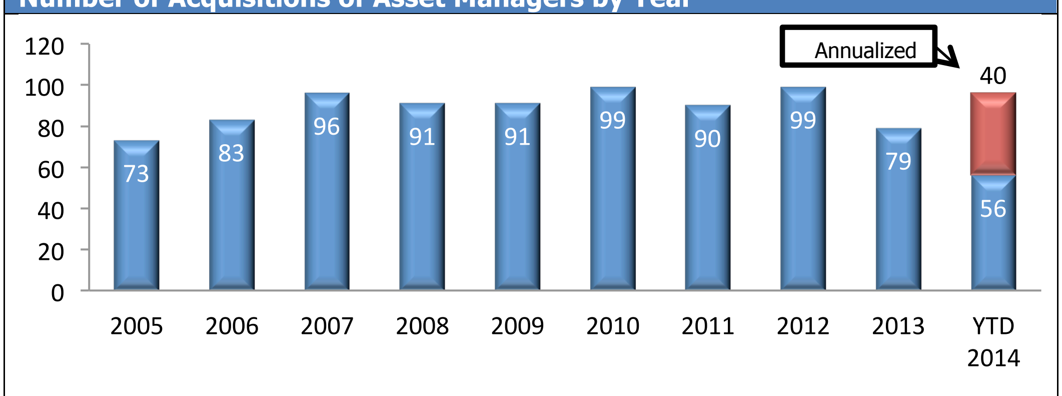
Investments and acquisitions in the alternative asset custody services industry

There are no publicly-traded pure play alternative asset custodians. The comparable universe of business sectors is presented in the following table.

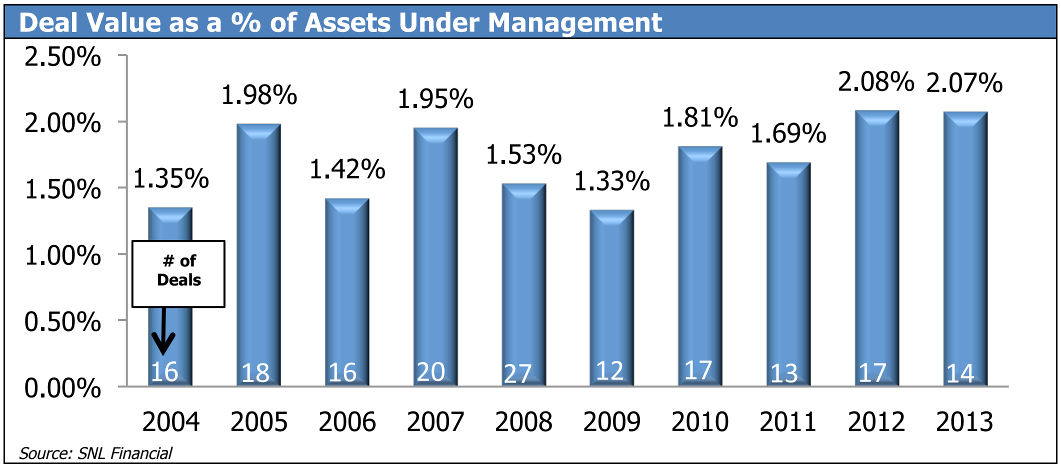
	Traditional Asset Managers	Mutual Funds	Alternative Asset Managers/ Service Providers	Trust Banks and Independent Trust Companies
Description	Companies that focus primarily on managing investments in public stock, bonds and other traditional "trading assets"	Companies that focus on providing investment vehicles to individual and retirement plans	Companies that focus on sourcing and managing investments in non-public alternative assets	Companies (banks and non-banks) that are established to perform the fiduciary responsibilities of a trust (custody of assets, record-keeping, etc.)
Business lines	Institutional fund management HNW managed accounts	Money market funds Stock mutual funds Bond funds ETF's	Real estate Private equity Hedge funds Commodity funds	Estate administration Asset management Escrow services Corporate trust services
Example Companies	AMG Affiliated Managers Group, Inc. BlackRock Legg Mason Global Asset Management	T.RowePrice Invest with confidence AllianceBernstein Janus	Apollo Alternative Assets The Carlyle Group Fortress	Boston Private Financial Holdings, Inc. Northern Trust State Street

There also have not been many investments in pure play alternative asset custodians. We believe that the firms in this sector should trade at price levels roughly equal to the valuations assigned to asset management firms because asset managers and alternative asset custodians generate similar operating margins. Activity in the U.S. asset management industry has been fairly consistent (between 73 and 99 transactions per year over the past decade). However, valuations of asset managers have fluctuated.

Number of Acquisitions of Asset Managers by Year



Source: SNL Financial



One alternative asset custodian deal closed in June 2009. Information of that transaction as gleaned from public sources is summarized below.

Seller	United Western Bancorp ("UWB")
Buyer	Equity Trust Company
Target	Certain assets of Sterling Trust Company
Closing	June 29, 2009
Price	$60.9 million; 25% paid in cash at closing, 75% paid via seller notes
Target Data	YTD revenues (6/30/09): $7.4 million YTD pre-tax income (6/30/09): $2.2 million
Valuation Metrics	4.0x Revenue (est.), 13.8x Pre-tax income (est.), 1.24% of AUC - valuation doesn't discount value of notes issued to seller
Comments	Equity Trust bought the assets of the self-directed IRA and qualified plan custodian businesses from UWB. UWB realized an after-tax gain of $35.9 million on the sale, which was equal to the bank's market capitalization on the closing date. UWB's primary subsidiary, United Western Bank, was taken over by the FDIC on 1/21/2011. Sterling had over 75,000 accounts and total assets under custody of $4.9B. Equity Trust claimed to be the largest provider of self-directed IRAs and 401ks after the transaction closed - $12B of assets under custody and 130,000 clients. Equity Trust is controlled by the Desich family.

Most of the participants in the alternative asset custody industry are privately-owned enterprises. Some of these enterprises have long histories and are organized as independent trust companies. There has been some private equity investment activity in the sector – Bluff Point Associates owns a large stake in Wealth Management Systems, Inc., a major participant in the automated IRA rollover sector. Some of the leading participants in the sector are listed below.

Provider	Location	Description
Equity Trust	Westlake, OH	Custody services for alternative assets and rollover IRAs; AUC of $12B and 130,000 accounts. Family-owned firm.
First Trust Company of Onaga	Onaga, KS	Custody services for self-directed IRAs. 80,000+ clients, AUC of $7B. Founded in 1978.
Goldstar Trust	Canyon, TX	Specialist custodian of precious metals IRAs; $2.2B under custodianship and 37,000 accounts. Trust-only branch of a Texas state bank (Happy State Bank). Happy State Bank has assets of $2.4B.
IRA Services Trust	San Carlos, CA	Custody services for alternative assets in self-directed IRAs; AUC of $4B and 40,0000 accounts.
Kingdom Trust Company	Murray, KY	AUC of $5B. 50.000 accounts. Focused on alternative asset custodial services in self-directed IRAs.
Millennium Trust Company	Oakbrook, IL	AUC of $11B. Alternative asset custody, IRA rollover programs and custody services for self-directed IRAs. Privately held.
New Direction IRA, Inc.	Louisville, CO	Provides custody services for self-directed IRAs. AUC under $2B.
Pensco Trust Company	San Francisco, CA	$10B of AUC; 50,000 clients, 40,000 unique assets under custody. Self-directed IRA custodian. Founded in 1989.
Trust Company of America	Centennial, CO	Over $10B of AUC. Founded in 1972. Owned by Gemisys Corporation. A specialized financial services information processor.

We believe that several platform companies will change hands in the coming year as investors are attracted to the growth opportunities in the business and owner/operators reach retirement age and seek liquidity.

Conclusion

We expect the alternative asset custody sector of the asset administration industry to attract investor attention in the coming years. The high-quality, recurring revenues generated by solid alternative asset custodians will intrigue both financial and strategic buyers. These businesses are especially attractive for commercial banks seeking to increase non-interest income and acquire long-term customer relationships.

For more information on the Alternative Asset Custody Services industry, please contact:

Christopher Gillock
Managing Director
312.870.6212
cgillock@coladv.com

Gina Cocking
Managing Director
312.425.8145
gcocking@coladv.com

Jeff Guylay
Managing Director
208.726.0788
jguylay@coladv.com

Colonnade is an independent investment bank focused on the financial services and business services sectors. Colonnade provides expert, objective advice on mergers and acquisitions, private placements, fairness opinions, valuation opinions and corporate finance issues for privately-held businesses, publicly-traded companies and financial sponsors. Our senior bankers bring extensive transaction experience, industry expertise, a process orientation and a sense of urgency to each engagement.