More perfect unions
Integrating to add value in asset management M&A

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Competition in the global asset management industry continues to intensify. Less lucrative economics are reshaping the operating environment. A shrinking number of firms with strong competitive advantages are seizing business from an oversupply of weaker, undifferentiated vendors with deteriorating prospects.

Thoughtful integration—either through mergers or acquisitions, or even between legacy business units developed organically within an asset management firm—can become a primary catalyst for improving enterprise value. This white paper explores examples of effective integration opportunities based on three primary conclusions:

- **Serial industry M&A has not realised substantial cost savings,** often because of misguided efforts to keep investment teams, distribution groups, brands or technology systems separate following a transaction. Clients have not rewarded such efforts with extra revenue to outweigh the duplicate expenses.

- **These duplicate costs typically reside in four primary areas:** organisational leadership, distribution strategy, enterprise and investment operations, and technology. Better integration efforts in these areas free up capital to invest in necessary cross-enterprise changes.

- **Effective integration requires a plan,** including dedicated resources, a future-state strategy that defines competitive advantage, and well-designed metrics and incentives that help define and make the difficult decisions often required.

Data cited in this paper and its figures, unless otherwise indicated, comes from several Casey Quirk research initiatives, including the Performance Intelligence financial benchmarking survey of asset managers, jointly conducted across the United States and Europe with compensation consultants at McLagan, a unit of Aon.

### The Curse of Legacy Costs

While transactions between asset managers have risen toward an apparent cyclical high in 2018, M&A has defined the industry for the past two decades, mostly because of its legacy economics:

- Low barriers to entry and a reliance on unique human capital created a wide range of targets, all of which generated high cash flow thanks to ad valorem pricing and a growing industry.

- Investment performance track records provided a form of brand equity that was difficult and time-consuming to replicate through organic competition.

- Strong organic growth in industry fundamentals supported rising multiples, providing opportunities for financial engineering.

- High margins throughout the industry obviated the need to explain cost-related synergies in transactions. They also encouraged a portfolio approach to corporate development—spreading risk across bets on capabilities—rather than a strategic plan.

Many of these same dynamics encouraged professionals to break away from larger firms and start new enterprises, impeding the consolidation such transaction activity usually implies.

Changing industry economics, however, have removed much of the air cover that stronger tailwinds provided asset management M&A transactions in the past:

- Organic growth is shrinking, as institutional retirement plans unwind and individuals fail to match the savings gap.

- Fee pressure is unrelenting, because of a rise in passive investing and clients repricing the value of a wide array of undifferentiated asset management products.

- Fixed costs are increasing, as expense growth shifts to technology-driven competitive advantages such as data, digital delivery, and operating process improvement.
As these shifting competitive dynamics pressure profit margins, asset managers are turning to M&A as a way to defend their franchises, further raising interest in M&A. Yet there is little apparent correlation between a firm’s assets under management and profitability.

Asset managers are turning to M&A as a way to defend their franchises.
Many asset managers have avoided functional integration based on several arguments:

- Appeal of distinctly branded, autonomous boutiques among professional buyers
- Distribution relationship continuity and niche product expertise
- Execution risk inherent in migrating or connecting technology platforms
- Joint executive leadership to mitigate cultural disruption

The benefits of such well-intentioned arguments have proved difficult to quantify—particularly in a marketplace driven by more customisation, multi-asset investing, brand-conscious individuals, and a less channelised path to distribution. The costs of such logic, however, are more visible. Comparing the general ledgers of asset managers shows that firms that embraced integration:

- Enjoy positive organic growth rates, as measured by net new flows, versus peers who were less integrated and had negative growth rates
- Provide shareholders 20% more profits
- Spend more on investment talent
- Cost roughly 8.5% less to operate

Source: Casey Quirk
Comparative Economics of Asset Managers by Level of Integration, 2017

Firm Cost Structure
By Level of Integration (% of revenue)

<table>
<thead>
<tr>
<th></th>
<th>Integrated Firms</th>
<th>Non-Integrated Firms</th>
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</thead>
<tbody>
<tr>
<td>Investments</td>
<td>28.4%</td>
<td>27.2%</td>
</tr>
<tr>
<td>Enterprise &amp; Investment Ops</td>
<td>16.2%</td>
<td>18.0%</td>
</tr>
<tr>
<td>Technology</td>
<td>6.5%</td>
<td>7.6%</td>
</tr>
<tr>
<td>Distribution</td>
<td>11.7%</td>
<td>13.5%</td>
</tr>
<tr>
<td>Management</td>
<td>4.0%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Margin</td>
<td>35.6%</td>
<td>29.6%</td>
</tr>
</tbody>
</table>

Three Year Firm Organic Growth
By Level of Integration (% of AUM)

Key
-7.6% -5.6% -3.6% -1.6% 0.0% 1.6% 3.6% 5.6% 7.6%

Notes: Sample includes U.S. and European firms. Excludes firms with less than $150 billion in AUM; integrated firms identified based on business model, brand integration, investment team integration, distribution team integration, and leadership integration. Firms are considered integrated if they have never made a substantial acquisition, or if they meet three or more of the integrated firm criteria.

Source: 2017 Casey Quirk Performance Intelligence Survey

The lattermost point is particularly important, as it reveals that legacy duplicate costs, built through decades of serial acquisition globally, amount to roughly $6 to $8 billion of annual run-rate expenses for the asset management industry.

“True integration will yield competitive advantages, but it requires tough decisions to realise the value of the combined organisations.”

Jeff Stakel, Principal, Casey Quirk
**Four Core Integration Levers**

Focusing integration efforts on four core functions can unlock significant value: on average, as much as 1% to 2.5% of revenues for each of the highlighted functions.

**Key Synergy Drivers, 2017 (% of revenue)**

- **Distribution Strategy**: 1.8%
  - Reorganising coverage structure and shifting spending toward technology and client experience

- **Organisational Leadership**: 2.4%
  - Reducing redundancies and migrating to metrics and rewards that favour collective execution of the new strategy

- **Enterprise and Investment Operations**: 1.8%
  - Identifying areas of leverage and overlap across functional support areas

- **Technology**: 1.1%
  - Deciding where systems integration creates efficiency—and where it doesn’t

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**1. Organisational Leadership**

Less integrated asset managers tend to have, on average, nearly twice the number of C-level executives employed by more fully integrated peers—usually resulting from a conscious decision to retain legacy executives. Many multi-affiliate asset managers insist on maintaining all key leadership following acquisitions, fearful that doing otherwise would upset clients or repel talent. Recent mergers of equals also relied on co-leadership structures. Architects of such mergers often argue that not only would a co-leadership structure prevent a legacy CEO from blocking a deal, but also it would telegraph to clients and employees that the transaction would preserve all elements of existing cultures.

Such leadership structures, however, have proved unwieldy. Governance can become too complex. Legacy cultures can become entrenched and territorial, rather than oriented toward change. Talent costs often balloon from the mistaken belief that enough key executives would voluntarily depart and eventually right-size the leadership group. Complex governance structures also hinder growth as it becomes harder to align on limited set of strategic priorities that will help differentiate the organisation.
2. Distribution Strategy
Less integrated asset managers, in general, have a higher proportion of their distribution officers in sales roles, reflecting legacy considerations. Affiliates within multi-boutique organisations usually are reluctant to relinquish dedicated sales officers who understand and promote their specific strategies, and all asset managers dislike disrupting client-facing talent and their relationships with asset owners and intermediaries.

Some of the headcount and cost reduction in distribution among well-integrated firms occurs from removing redundancies. But such firms also realise that integration creates an opportunity to reprioritise sales resources. Effective integrators aim to better leverage the distribution headcount they have.

3. Enterprise and Investment Operations
Integrated asset management firms spend less than their peers across investment operations, middle and back-office systems and enterprise operations (legal, finance, compliance, risk management, internal audit, and human resources). Much of their efficiency stems from two key differences with less integrated firms:

• Lower outsourcing costs. Non-integrated firms spend more on outsourced systems and services, reflecting more complicated business models: multiple trading desks, diverse portfolio management requirements and platforms, and siloed reference and product data that support highly distinct (and sometimes competing) investment strategies. In addition, integrated firms have pricing leverage with outsourcing firms thanks to their consolidated model. This also simplifies governance and oversight.

• Lower shared services costs. Integrated asset management firms are able to leverage enterprise shared services. This results in lower headcount, less technology expense and fewer duplicative and consolidating activities. These firms also have a more simplified control environment; a more centralised legal, compliance, and internal audit functions across fewer registered investment advisers and entities requiring separate disclosures and reporting. Integrated firms save a full point of margin, on average, in legal and compliance costs alone.

4. Technology
Most merging asset managers trumpet systems integration as a value driver. In reality, cost synergies from combining technology investments are more elusive:

• Many asset managers already have spent significant effort squeezing technology costs through outsourcing and rationalisation efforts.

• Efforts to rationalise or decommission platforms are more difficult and take longer than anticipated because of linkages with multiple associated systems, end-user computing tools, customised applications, different operating processes and complex data.

• Execution risk scares executives away from tackling large integration projects, fearing that botched or longer-than-expected work will create negative headlines and jeopardise client relationships.

• Lack of a partnership model between business and technology drives competing priorities and hinders decision-making and adoption. This can be further exacerbated through stakeholders’ limited knowledge of how the underlying technology supports the business model, and vice versa.

Such concerns have merit. Firmwide systems integration or joint outsourcing efforts are complicated exercises, and undertaking them without experienced practitioners or a clear target model can be perilous. Effective integrators, however, have realised that the majority of technology cost savings from merging asset management operations come from six specific areas:

01. Market data
02. Hardware, primarily networks and data centers
03. Client relationship management tools
04. Cyber and disaster recovery programmes
05. HR and finance enterprise systems
06. Investment systems including order management and trade processing
Effective Integration Programmes

Functional integration in asset management often reflected a “do no harm” mentality. A well-founded fear of compromising culture or investment capability meant that organisations favoured using a lighter touch on integration planning and execution: calling little attention to it, avoiding dedicated integration management resources, and slowing or stopping efforts at the first signs of resistance. Cost synergies typically reflected top-down estimates, not bottom-up planning. Thick profits and strong organic growth insulated firms from making areas measurable progress. Consequently, many firms de-emphasised integration as a growth option. As the duplicate costs of poor or slow post-merger integration begin to bite into shrinking margins, more firms must consider the benefits of effective integration programmes—particularly following sizable deals. Thoughtful integration programmes minimise the cultural and human capital risks of combinations while simultaneously taking steps to ensure progressive, successful execution.

Best Practices Among Effective Integration Programmes for Asset Managers

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<tr>
<th>Legacy Integration Challenges</th>
<th>Future Success Characteristics</th>
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<tbody>
<tr>
<td><strong>Vision</strong></td>
<td><strong>Actionable Future-State Strategy:</strong> A future-state strategy detailing how integration creates enterprise value, and brings clear and measurable benefits to both investors and shareholders</td>
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<tr>
<td>Unclear future-state vision that outlines how clients benefit from new competitive advantages and investments capabilities gained through integration</td>
<td><strong>Thorough Financial Plan:</strong> A financial plan that identifies enhancements to investments, distribution and technology that will drive revenue, maximise cost synergies and identify the best opportunities to reinvest capital</td>
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<tr>
<td><strong>Overlap</strong></td>
<td><strong>Robust PMO:</strong> A strong project management office to enact governance, decision-making and clear protocols, track progress on key metrics, and drive a change management plan</td>
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<tr>
<td>Reluctance to make tough decisions about duplicate leadership roles, overlapping investments, functional costs and new culture</td>
<td><strong>Defined Accountability:</strong> Clear roles and responsibilities to drive change and execution, avoiding co-heads and dual roles</td>
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<tr>
<td><strong>Change Management</strong></td>
<td><strong>Comprehensive Communication Plan:</strong> A thorough and well-structured communication plan with clear accountability and aligned with the future state strategy</td>
</tr>
<tr>
<td>Inexperience with change management, particularly around governance, process, cultural implications and accountability in an industry that historically has been characterised by growth</td>
<td><strong>Structural Alignment Plan:</strong> Organisational structure and compensation aligned with future goals and objectives, including leadership representation from legacy firms and across functional areas</td>
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<tr>
<td><strong>Disruption</strong></td>
<td></td>
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<tr>
<td>Fear of client and key stakeholder disruption driven by incomplete visions and insufficient communication with affected stakeholders (shareholders, clients, employees, etc.)</td>
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<tr>
<td><strong>Organisational Model</strong></td>
<td></td>
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<tr>
<td>Legacy organisational models across leadership, investments and distribution that reflect prior firm positioning rather than a collective future vision</td>
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Source: Casey Quirk
Conclusion
Asset management remains a talent-driven business, and integration may not be the best answer in many cases. Investment teams prize autonomy and view their approaches to portfolio construction and trading as extensions of highly proprietary intellectual property—particularly for capacity constrained strategies. Certain legacy brands have loyal client followings and may suffer from integration or absorption. And maintaining elements of a partnership culture that appeal to high performers may justify some separate functions. Even putting aside execution risk, there are often strategic reasons to maintain multiple legacy elements of operating models within asset managers. Ever-increasing pressure on industry economics, however, make getting deeper and wider integration right within and between asset management businesses. Duplicate costs that do not clearly and directly result in competitive advantage deserve scrutiny, despite the checkered history of integration efforts throughout the industry’s history. Leaders of asset management businesses can improve integration prospects—therefore driving higher organic growth and better efficiency—with careful planning and strategic decision making at the functional level, rather than emotional or risk-avoiding compromises solely at the enterprise level. With the right amount of forethought, asset management firms can unlock, not damage, value through selective integration.