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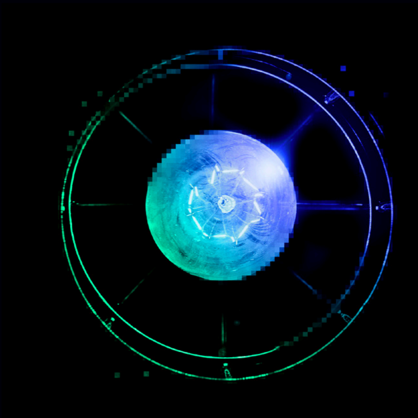

More Perfect Unions

Integrating to Add Value in Asset Management M&A

Unsuccessful industry M&A are less likely a function of poor industrial logic than **incomplete and ineffective post-merger integration** that maintained separate systems, teams or brands. **Lack of integration has created between 5%-8% of additional run-rate costs for organizations, roughly $6 to $8 billion** per year industrywide.

Functional integration at multiple levels—internal business units, bolt-on capabilities, or enterprise-wide M&A**—creates competitive advantages at scale, as well as sizable economic benefits.** Firms that are more fully integrated:

- Among top-quartile competitors, **grew net new flows more than twice as fast**
- Support **a cost structure that is 8.5% lower** than non-integrated peers
- Maintain **profitability levels that are 20% higher**

Successful integration strategies, either organic or post-merger, **take difficult but decisive action across four key sources of legacy duplicate costs** measured as a proportion of revenue:

- **Organizational models:** Avoid co-leadership structures and delayer effectively, usually reducing senior headcount and related costs by 60%
- **Distribution strategy:** Dechannelize distribution groups and shift spending from sales compensation toward new talent and technology that improve client experience and service efficiency, slashing functional costs by 13%
- **Enterprise and investment operations:** Centralize core business functions, governance, and trading processes to cut legal, fund accounting, risk management, and outsourcing costs by 10%
- **Technology:** Tackle duplicate costs across four fronts: data, people, location and infrastructure – reducing costs by 14%

Asset managers with successful integration programs **share some common characteristics:**

- A clear **future-state vision and financial plan** that outlines and funds new competitive advantage by aggressively realizing cost synergies
- An ability to face **tough decisions** about duplicate leadership, capabilities, and costs
- **Change management expertise,** particularly around **project management skills**
- **Consistent communication protocols** with all affected stakeholders
- **New incentives** that reward combined success as much as yesterday's promises

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Introduction

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.

In response, many asset management firms are turning to strategies reliant on scale, hoping that size will magnify competitive advantage, provide efficiencies, and fund changes required to meet shifting client needs. Such beliefs are fueling cyclical highs in mergers and acquisitions between asset managers. But they also have raised questions about the effectiveness of inorganic strategies, as there are few anecdotes of effective transactions across an industry shaped by M&A deals.

Lackluster results of mergers and acquisitions in asset management don't stem from poor industrial logic. If anything, building competitive advantage at scale—in product, distribution, systems or operating model—has become an even greater strategic imperative. Instead, poor post-merger integration planning and execution has emerged as a primary culprit. Asset management executives, reluctant to disrupt talent and hamstrung by the costs of legacy businesses, struggled to make the hard decisions necessary to realize the value of the combined organization.

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 realized 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:** organizational 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.

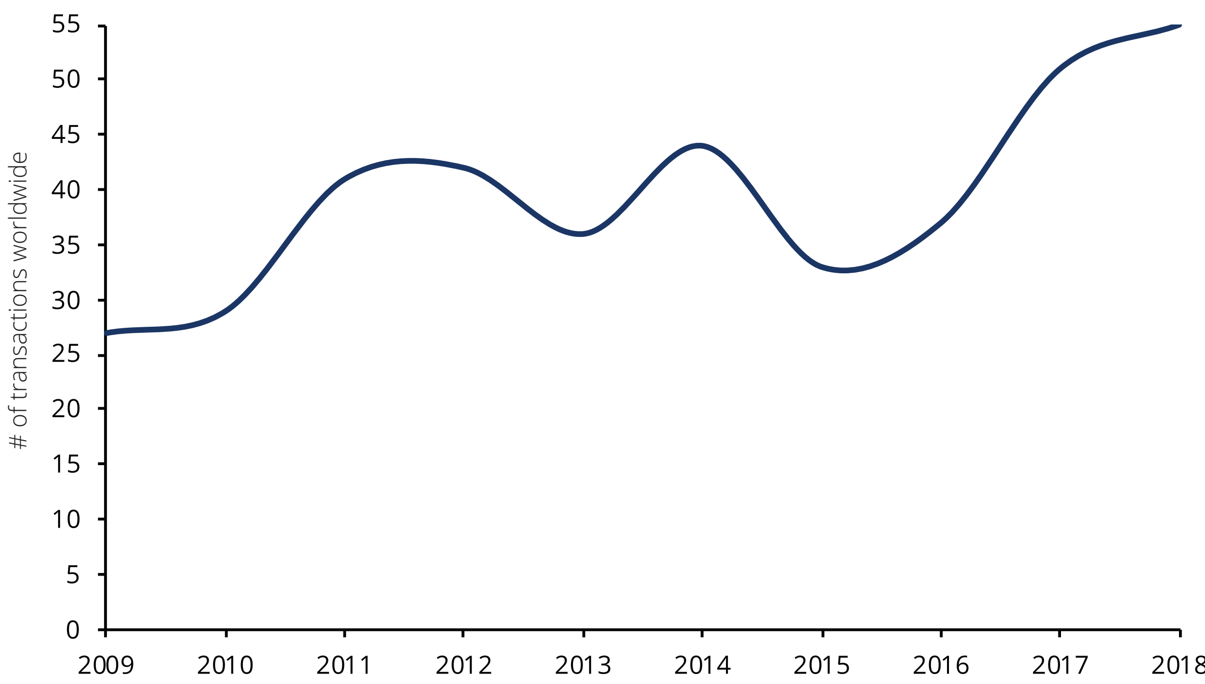
The Curse of Legacy Costs

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.

Exhibit 1: Transactions Between Asset Managers

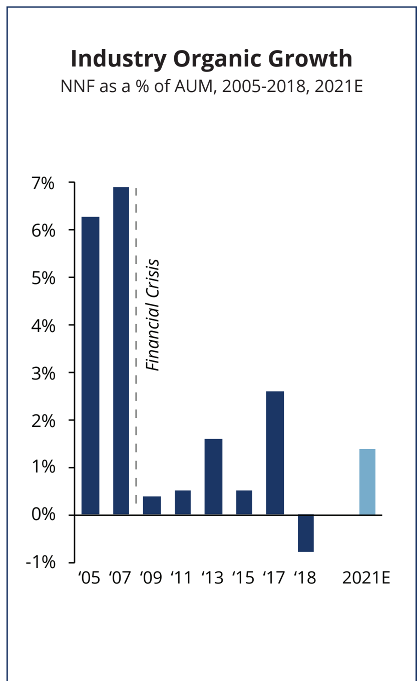


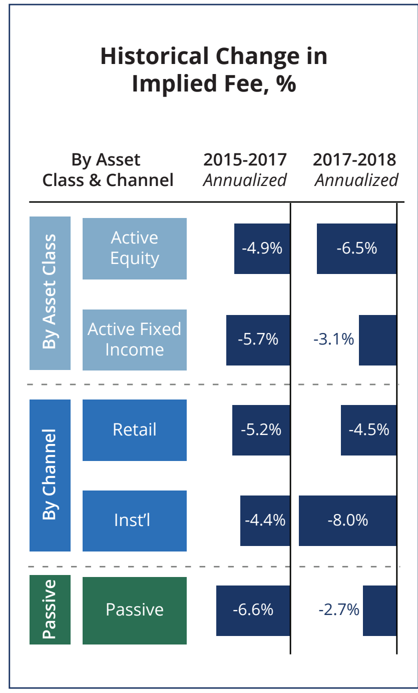
Sources: Capital IQ, Casey Quirk analysis of publicly traded asset management company data

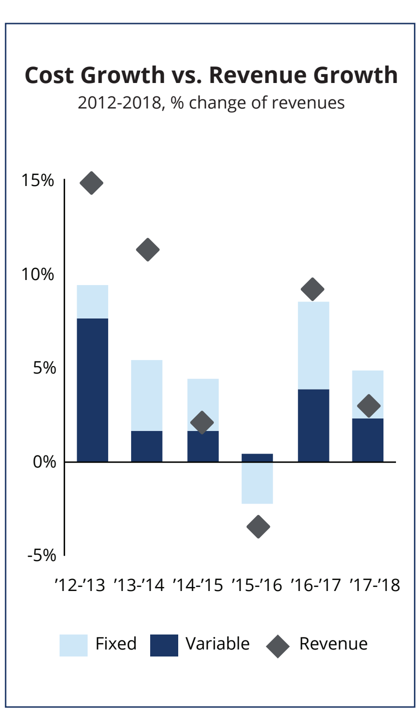
Changing industry economics, however, have removed much of the air cover that stronger tailwinds provided asset management M&A transactions in the past:

- 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.

Exhibit 2: Operating Environment Pressures





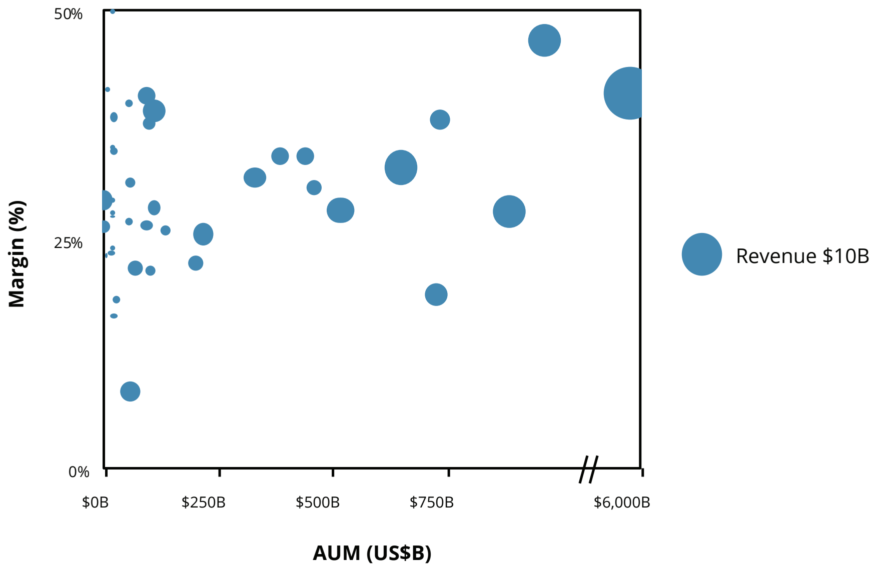


Note: Market metrics are global ex-China; cost and revenue growth metrics include U.S. and European firms.

Sources: Casey Quirk/McLagan Performance Intelligence 2018 Study, Casey Quirk research

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.

Exhibit 3: Publicly Traded Asset Managers Worldwide by AUM and Operating Profit Margin, 2018



Notes: U.S. and European firms. Excludes alternative asset managers.
Sources: Morningstar, Capital IQ, and Casey Quirk Analysis

Such data underscore the fact that size and scale are two different things. Gaining more assets under management, an increasingly outmoded metric, does not make a firm more competitive. However, creating greater economic efficiencies and allowing more capital investment, in areas where either the market recognizes your competitive advantage or you are strategically building one, does. Such efforts create the ability to deliver value to clients, shareholders, or both in a way that rivals struggle to match without overextending their cost base.

Many industry transactions have prioritized size instead of focus or leverage, creating many problems that stem from a common source—poor post-merger integration at multiple levels:

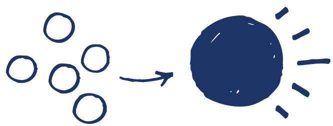
- **Between internal business units within an asset manager,** or affiliates within a multi-affiliate asset manager. Integration efforts can create more unified brands promoted by bigger marketing budgets, a single high-demand product suite, and operational efficiencies in the middle and back offices.

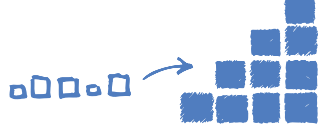
- **Through the acquisition of bolt-on capabilities,** usually in the form of new investment teams. Integration efforts can build larger flagship products to attract net flows, strengthen multi-asset and asset allocation skills, augment research efforts and better leverage sunk costs in distribution.

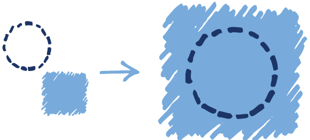
- **As part of larger-scale mergers of equals.** Cost synergies can result from such transactions, but strategically planned combinations can unite complementary geographic footprints, customer bases, and investment skill sets. Mergers also help build more brand equity to leverage globally.

Exhibit 4: Asset Management Integration Examples

	1 Internal Business Unit Integration	2 Bolt-on Capability Transactions	3 Enterprise-wide M&A
Examples	• Multi-affiliate integration • Functional streamlining • Front-to-back transformation	• New investment bolt-ons • New distribution channels • Vertical integration	• Mergers of equals • Market segment consolidation
Common Industrial Logic	• Realize market dynamics can no longer support redundant costs • Seek operational efficiencies in middle and back-office functions • Leverage "single spine" architecture across front-to-back office • Unify marketing and brand under centralized campaigns • Develop single product suite to streamline go-to-market efforts	• Broaden asset class capability to gain more benefit from investment in technology and data • Leverage distribution capabilities • Bolster asset base and create at-scale capabilities • Create asset allocation offering at the center of the investment engine • Access new clients or deliver differentiated client experiences	• Spread cost across a larger asset base and optimize operating platform • Recognize "go-it-alone" strategy is untenable • Leverage complementary geographic market coverage with specialist knowledge • Enhance customer experience, and toolkit • Create a global brand







Source: Casey Quirk

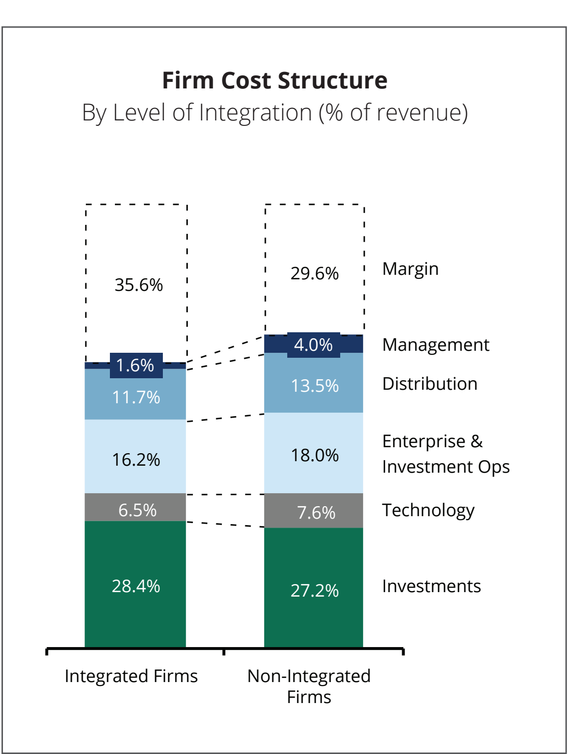
Many asset managers have avoided functional integration based on several arguments:

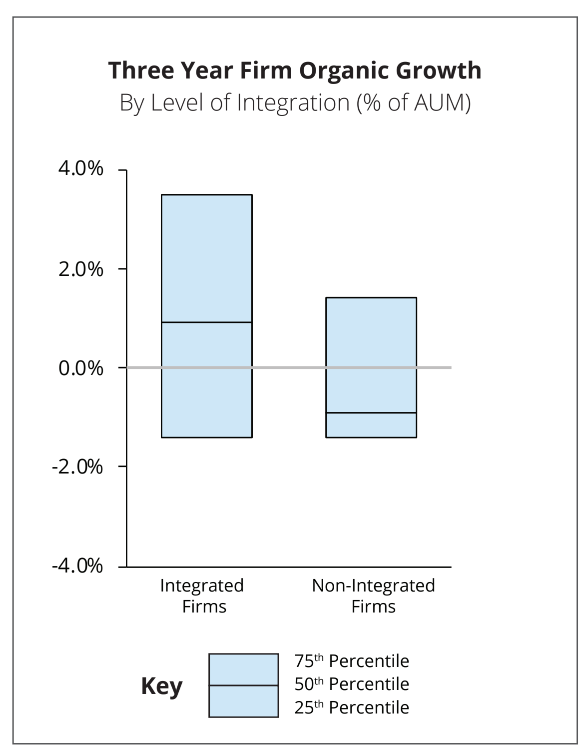
- Appeal of distinctly branded, autonomous boutiques among professional buyers
- Distribution relationship continuity and niche product expertise
- Execution risk inherent in migrating or connecting technology platforms
- Joint executive leadership to mitigate cultural disruption

The benefits of such well-intentioned arguments have proved difficult to quantify—particularly in a marketplace driven by more customization, multi-asset investing, brand-conscious individuals, and a less channelized 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

Exhibit 5: Comparative Economics of Asset Managers by Level of Integration, 2017





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.

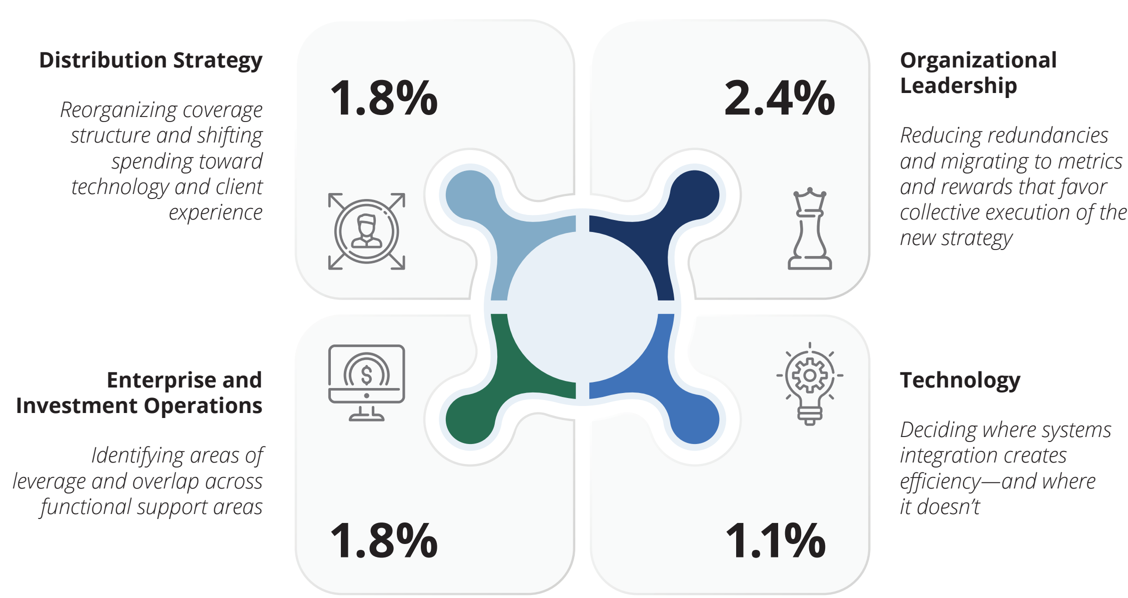
Source: 2017 Casey Quirk Performance Intelligence Survey

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.

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.

Exhibit 6: Key Synergy Drivers, 2017 (% of revenue)



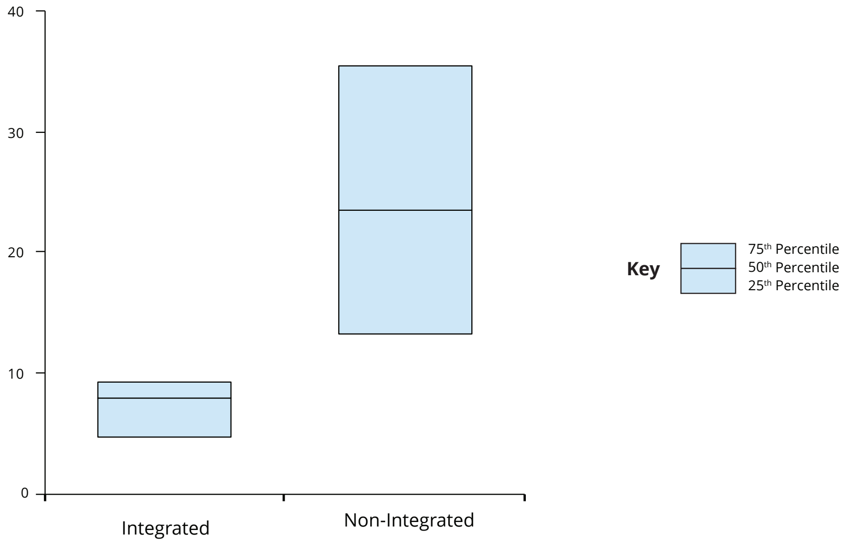
Source: Casey Quirk/McLagan Performance Intelligence

1. Organizational 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 rightsize 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 organization.

Exhibit 7: Executive Headcount, 2017



Note: Defined as C-level executives with functional leadership responsibilities.
Source: Casey Quirk/McLagan Performance Intelligence

Successful efforts to integrate leadership share two common characteristics:

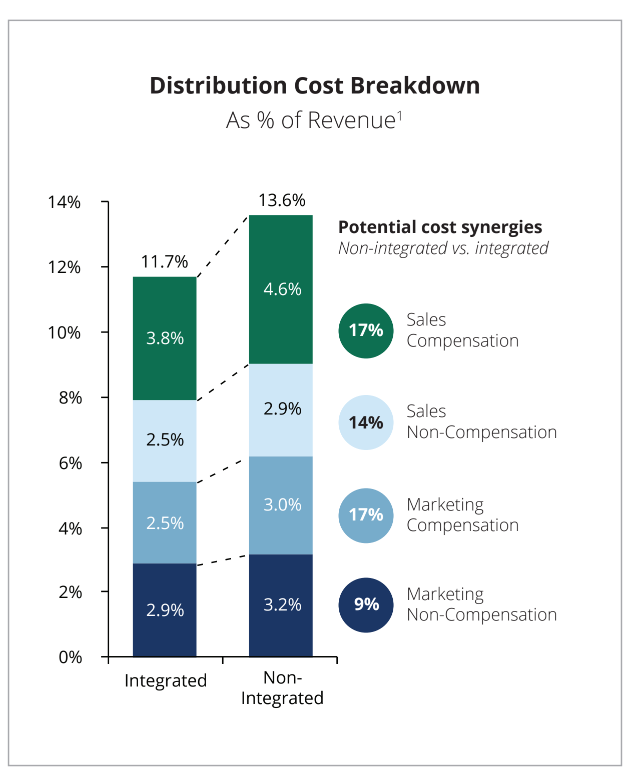
- *Difficult decisions and conversations*. Choosing one leader per function can be emotionally and culturally risky, but there are several potential benefits beyond sizable cost savings. Governance becomes efficient; accountability becomes clear. Most importantly, removing joint leadership structures indicates that success depends on promoting a new, change-oriented culture (and often a unified brand), rather than protecting legacies.

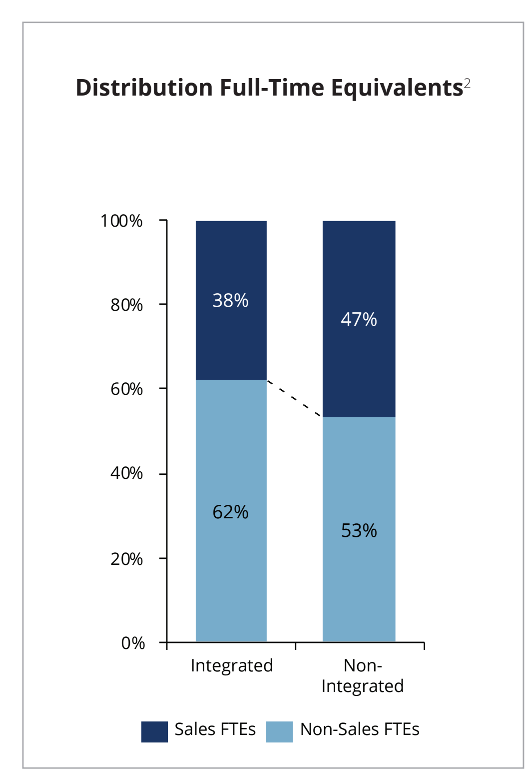
- *New, and rapidly deployed, incentive systems*. Effective integrators avoid the temptation of freezing legacy compensation agreements for a significant duration, trying to prevent defections. Doing so entrenches behaviors, making required change more difficult. Effective integration plans immediately address incentives, aligning talent toward success metrics that represent integrated goals and objectives. Compensation structures linked directly or indirectly to overall enterprise value, not just a team's or affiliate's contribution, can better encourage other firmwide integration efforts.

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 organizations 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.

Exhibit 8: Distribution Synergies, 2017





Notes:
[1] Sales is defined as retail wholesalers and institutional sales staff, relationship managers, and consultant relations staff.
[2] Sales is defined as retail wholesalers and institutional sales staff and Non Sales is defined as relationship managers and consultant relations staff

Source: Casey Quirk/McLagan Performance Intelligence

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

- *Better use of distribution technology.* Using more technology—cleaning and organizing client and marketplace data, deploying analytics to better prospect potential clients, and implementing applications that automate and streamline client onboarding and reporting, among other functions—defines well-integrated asset managers. Simply unifying client data into a single source of truth, rather than multiple databases that create duplicate calling efforts and frustrated clients, yields higher efficiency. Our recent white paper, *Distribution 2.0: How Technology will Redefine Relationships with Asset Management Clients,* provides further detail.

- *Less channelized organizations.* A hyperspecialized approach to segmentation made more sense before industry growth slowed. The outcome-oriented and customized sales and servicing requirements of large institutions and large intermediaries are becoming more similar and

resource-intensive at the same time. Well-integrated firms often invest in engagement models designed to meet the complex information and customization requirements of large clients, leveraging them effectively across many different types of clients, rather than building separate and somewhat redundant engagement processes for a high number of segments.

- *A different mix of distribution talent.* As the number of large asset owners and intermediary gatekeepers consolidates and professionalizes further, highly compensated sales professionals with client relationships are necessary but no longer sufficient, as most of these professionals are familiar with the same group of large capital pools. Well-integrated asset managers redeploy costs into new forms of talent that help support next-generation engagement models: data scientists, marketing professionals, and operating officers with skill in process refinement. Even distribution organization leaders, formerly gleaned from the ranks of effective salespeople, now come from many different places, bringing new skills to bear. This makes distribution organizations of well-integrated firms leaner and more powerful over time.

Organizational reviews also can help better integrate distribution functions by:

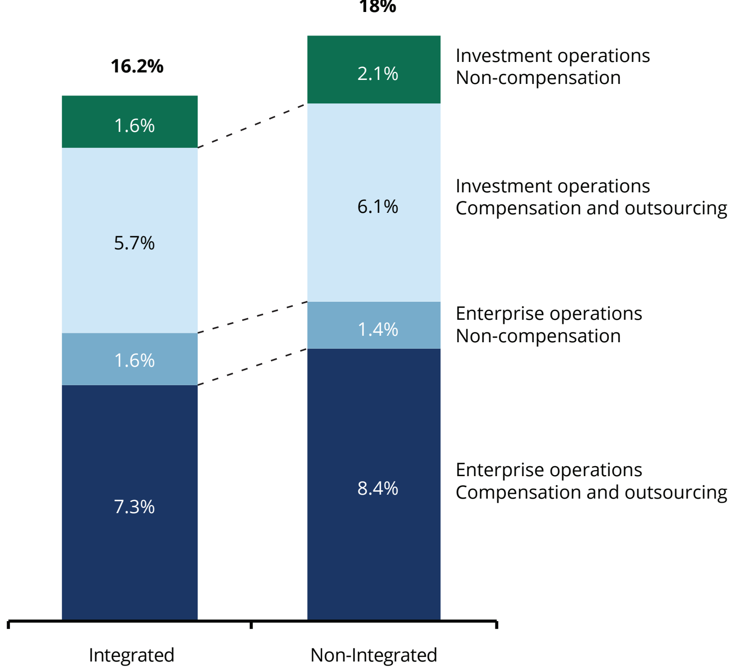
- *Diagnosing and eliminating overlap* between segment-level functions, better aligning segment-level coverage and removing duplicate resources across clients that are becoming more similar over time.
- *Creating transition plans in at-risk client accounts*, identifying clients that may view integration unfavorably and proactively using communications strategies to outline the customer-level benefits of a transaction or integration exercise.
- *Realigning resources* from segments with lower growth potentials to ones that will realize more demand for the firm's products and services.

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 centralized 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.

Exhibit 9: Enterprise and Investment Operations Metrics by Level of Integration, 2017 (% of revenue)



Note: Excludes firm-specific outlier expenses in transfer agency, DC plan administration, and other select categories.
Source: Casey Quirk/McLagan Performance Intelligence

4. Technology

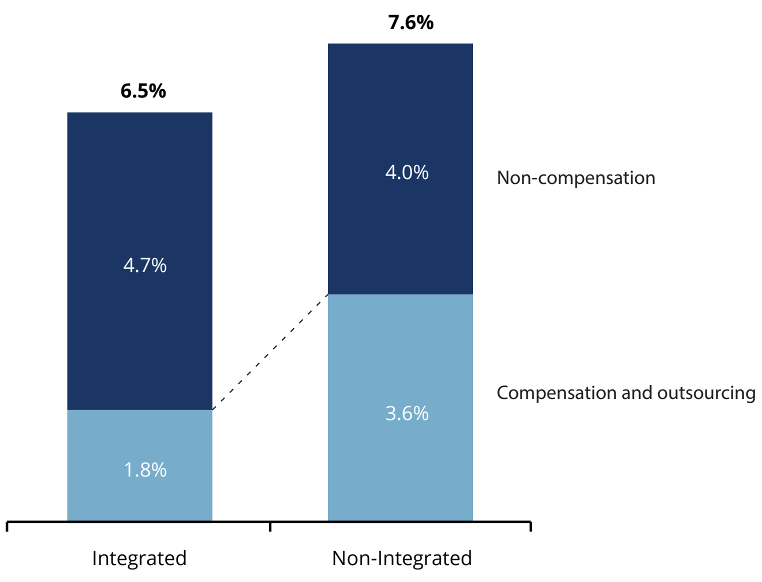
Most merging asset managers trumpet systems integration as a value driver. In reality, cost synergies from combining technology investments are more elusive:

- Many asset managers already have spent significant effort squeezing technology costs through outsourcing and rationalization efforts.
- Efforts to rationalize or decommission platforms are more difficult and take longer than anticipated because of linkages with multiple associated systems, end-user computing tools, customized 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 jeopardize 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 realized that the majority of technology cost savings from merging asset management operations come from six specific areas:

1. Market data
2. Hardware, primarily networks and data centers
3. Client relationship management tools
4. Cyber and disaster recovery programs
5. HR and finance enterprise systems
6. Investment systems including order management and trade processing

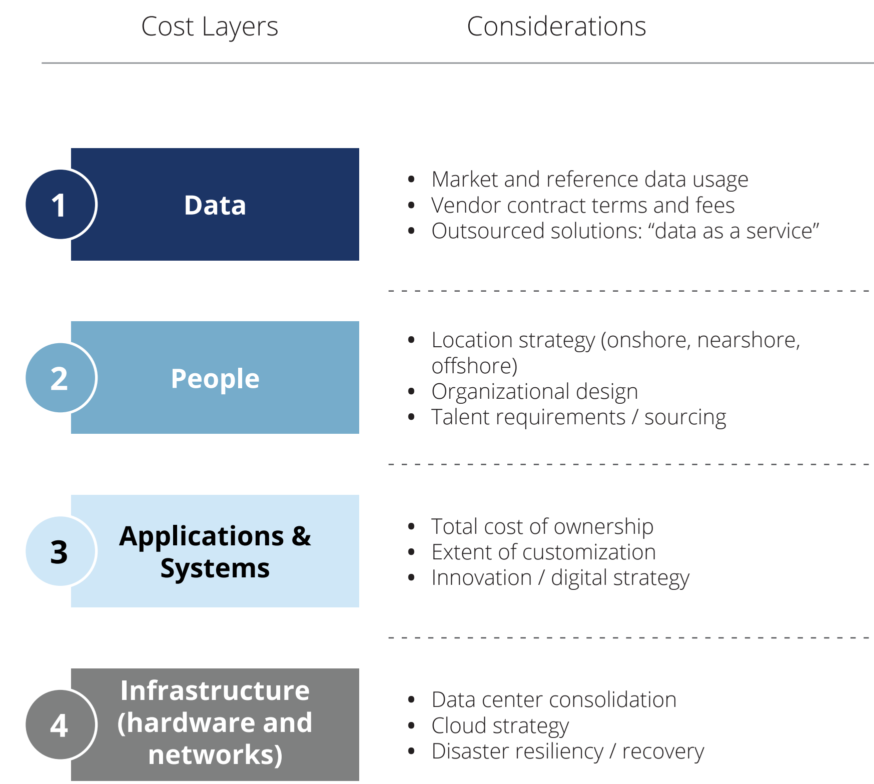
Exhibit 10: Selected Technology Metrics by Level of Integration, 2017 (% of revenue)



Source: Casey Quirk/McLagan Performance Intelligence

Integrating assets or applications that are not directly tied to the business, but still support the overall enterprise, tends to be quicker and carries less execution risk. This should be the focus at the start of an integration effort, as success here builds organizational confidence in tackling multifaceted technology conversions and helps achieve target cost synergies. Integrated firms immediately benefit from purchasing power in market data and infrastructure whereas some synergies require deeper functional integration, such as migrating to a single instance of CRM. Integration across middle- and back-office systems is key to significant technology synergies, but are complex, longer in duration, and are expensive to execute. These synergies are also dependent on data integration, extent of reliance on third party providers and custodians, and a clear future-state operating model. The extent of integration, and associated savings, depends on the business strategy overlap across the organizations.

Exhibit 11: Technology Cost Considerations



Source: Casey Quirk

Effective Integration Programs

Functional integration in asset management often reflected a "do no harm" mentality. A well-founded fear of compromising culture or investment capability meant that organizations favored 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 measurable progress. Consequently, many firms de-emphasized 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 programs—particularly following sizable deals. Thoughtful integration programs minimize the cultural and human capital risks of combinations while simultaneously taking steps to ensure progressive, successful execution.

Exhibit 12: Best Practices Among Effective Integration Programs for Asset Managers

Legacy Integration Challenges			Future Success Characteristics
Vision	*Unclear **future-state vision** that outlines how clients benefit from new competitive advantages and investments capabilities gained through integration*		***Actionable Future-State Strategy:** A future-state strategy detailing how integration creates enterprise value, and brings clear and measurable benefits to both investors and shareholders*
Overlap	*Reluctance to make **tough decisions** about duplicate leadership roles, overlapping investments, functional costs and new culture*		***Thorough Financial Plan:** A financial plan that identifies enhancements to investments, distribution and technology that will drive revenue, maximize cost synergies and identify the best opportunities to reinvest capital*
Change Management	*Inexperience with **change management,** particularly around governance, process, cultural implications and accountability in an industry that historically has been characterized by growth*		***Robust PMO:** A strong project management office to enact governance, decision-making and clear protocols, track progress on key metrics, and drive a change management plan* ***Defined Accountability:** Clear roles and responsibilities to drive change and execution, avoiding co-heads and dual roles*
Disruption	*Fear of **client and key stakeholder disruption** driven by incomplete visions and insufficient communication with affected stakeholders (shareholders, clients, employees, etc.)*		***Comprehensive Communication Plan:** A thorough and well-structured communication plan with clear accountability and aligned with the future state strategy*
Organizational Model	***Legacy organizational models** across leadership, investments and distribution that reflect prior firm positioning rather than a collective future vision*		***Structural Alignment Plan:** Organizational structure and compensation aligned with future goals and objectives, including leadership representation from legacy firms and across functional areas*

Source: Casey Quirk

Well-designed integration plans both anticipate and mitigate execution risks. They include the following five elements:

1. **An actionable future-state strategy.** Favoring status quo strategies provides that mergers and acquisitions only result in larger, more uncompetitive asset managers, preserving legacy functions and capabilities that cannot compete effectively in a shifting operating environment. Building a clear vision of a competitive future state helps focus integration efforts on functions that represent clear advantages or efficiencies.

2. **A thorough financial plan.** Most internal or inorganic combinations of capabilities in asset management create overlapping capabilities. Effective integrators address such duplicate costs head-on. Strong financial planning and analytics, as well as detailed modeling and scenario analysis, provide the necessary data and frameworks to help remove emotion from these tough decisions. Leaders can then debate resulting trade-offs in terms of future enterprise value, rather than legacy considerations.

3. **A robust project management office.** Many leaders at investment firms have little experience with true change management. Additionally, as part of maintaining "business as usual," some asset management executives attempt to run integration planning off the side of their desks. Effective integrators realize the exercise is a full-time job and staff a strong project management office to establish governance, decision-making frameworks, and clear protocols. Such efforts help asset managers assign and monitor accountability—reducing the risk that leaders of one legacy counterparty blame the other for integration failures.

4. **A comprehensive communication and change management plan.** Institutional investors and intermediary gatekeepers increasingly understand that a challenging operating environment will force their asset management partners to adapt and change, steps that may require inorganic efforts. They dislike surprises, which often foreshadow disruption. Effective integrators build detailed internal and external communication strategies and embrace change management approaches, with feedback loops, that make clients and employees stakeholders in the process. They highlight—in measurable ways—the benefits from integration efforts.

5. **Structural alignment and well-designed incentives.** Well-integrated firms organize resources that support the competitive advantages required to win in the future, rather than preserving status quo structures that reflect prior strategies. They attempt to distribute key positions among representatives from heritage firms, but they also avoid maintaining outmoded roles simply to balance scales between merger counterparties. Most importantly, they quickly implement incentives linked more to the future success of the combined entity, rather than load up pay packages with simple retention bonuses that reflect pre-merger objectives.

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.

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