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Skill through scale? The role of M&A in a consolidating industry

Investment Management
2017 M&A Outlook

Deteriorating economics, distributor consolidation, the need for new capabilities, and a shifting value chain are combining to set off an **accelerated and different round of merger & acquisition (M&A) activity** in the investment management industry.

We expect to see brisk M&A activity continuing in 2017 (and beyond) driven **more than ever before by consolidation pressures**, and centered on **four primary deal types:**

- Transformative scale acquisitions
- Pure consolidating deals
- Capability-based transactions
- Value chain-extending transactions

Four **strategic catalysts will drive M&A activity in the sector:**

- Deteriorating industry economics
- Distributor consolidation
- A need for new capabilities
- A shifting value chain

Successful transactions will be characterized by:

- Clear cost and revenue synergies to unlock investment capital
- Leveraging data and technology to drive competitive advantage
- Better positioning to respond to fiduciary-oriented change

Most deals will require **substantially greater integration** than the industry has tackled historically and make pre- and post-deal integration planning essential. In many cases, integration will require substantial restructuring of investments, distribution, and operations. Successful transactions will be characterized by:

- Integrated leadership team and governance structures
- Competitive investments and distribution organizations
- Effective incentive alignment programs
- Brand and firm positioning
- Streamlined operating models

Table of Contents

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Casey Quirk

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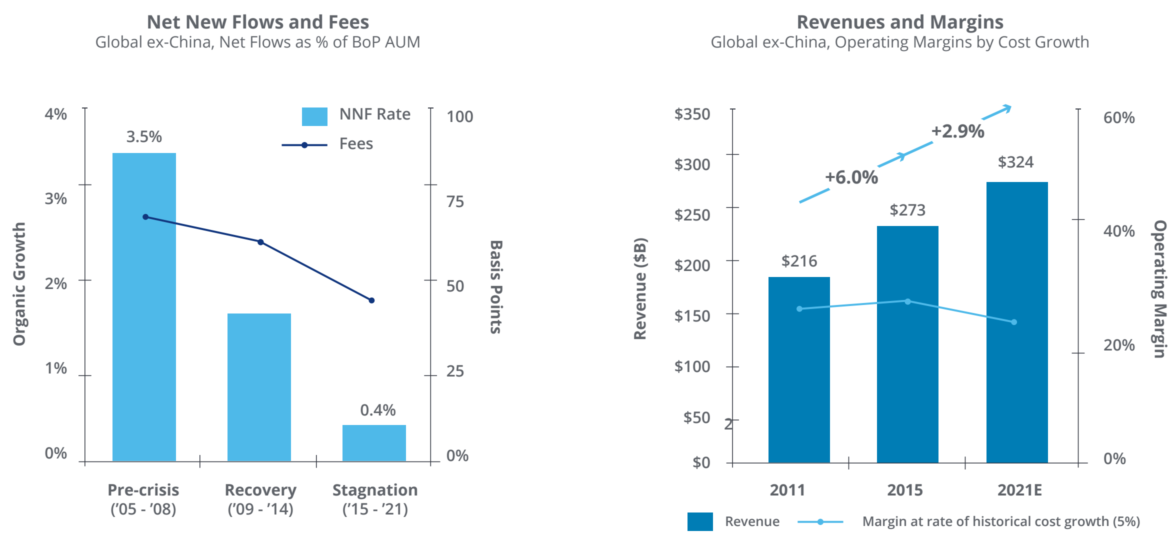
Casey Quirk helps clients develop broad business growth strategies, improve investment/product appeal and growth prospects, evaluate new market and product opportunities, and enhance incentive alignment structures. Our unparalleled industry knowledge and experience, detailed proprietary data, and global network of relationships make Casey Quirk a leading advisor to the owners and senior executives of investment management firms in the world.

Introduction

Investment management has become a fiercely competitive industry, increasingly shaped by the same winner-take-all and consolidation dynamics influencing other maturing financial services sectors. The gap is widening between leading and lagging asset/wealth management firms, as they deal with—to varying degrees of success—a cost and customer conundrum that is challenging revenue growth and profitability in a maturing, oversupplied market (Figure 1).

Figure 1: Global Asset Management Industry: Key Metrics



Source: U.S. Institue/Casey Quirk/McLagan Performance Intelligence Study and Casey Quirk Analysis

Strategy consultants from Casey Quirk describe a shifting operating environment in their 2016 white paper, *Survival of the Fittest: Defining Future Leaders in Asset Management*.

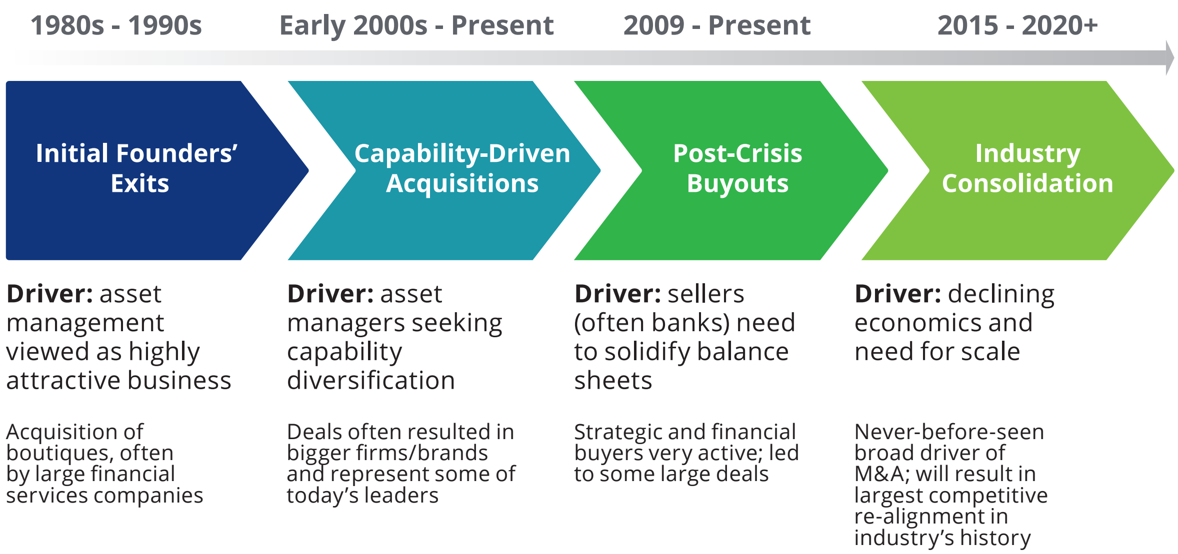
Key drivers of the new competitive environment include:

Costs: Dwindling market returns, slowing organic growth, and contracting margins reveal that the industry is not as scalable as previously believed, with expected fixed cost increases (including technology upgrades to meet new compliance standards and digitalization demands) outpacing likely future revenue growth. Additionally, as long-term capital market returns decline, and passive asset management products become more popular, fee pressure will rise.

Customers: As individual investors, rather than institutions, begin to power revenue growth, investment management is starting to resemble other consumer-focused industries facing dramatically changing buying patterns; requests for innovative products; expectations for a differentiated; personalized experience and customized outcomes; and fee sensitivity.

With the investment management industry's traditional cost and operating models under pressure, forward-thinking asset and wealth managers are looking for new ways to differentiate, expand capabilities, and increase revenue. One way to do this is through cost-cutting, finding new sources of funds for transformation. Those investment management organizations that focus on amassing and using available capital to invest in mergers, acquisitions, and partnering arrangements—rather than those that pay out free cash as compensation or dividends—will likely be better positioned to manage marketplace challenges and opportunities, and build the capabilities and scale they need to power revenue growth. Unlike previous transactions in the investment management industry, consolidation pressures—a focus on scale to combat deteriorating economics as well as support necessary reinvestment in new skills—will drive the next round of M&A.

Figure 2: Phases of Investment Management M&A



We expect that most investment management M&A deals in 2017 and the next few years will be strategic, driving valuations upward, with the following primary deal types:

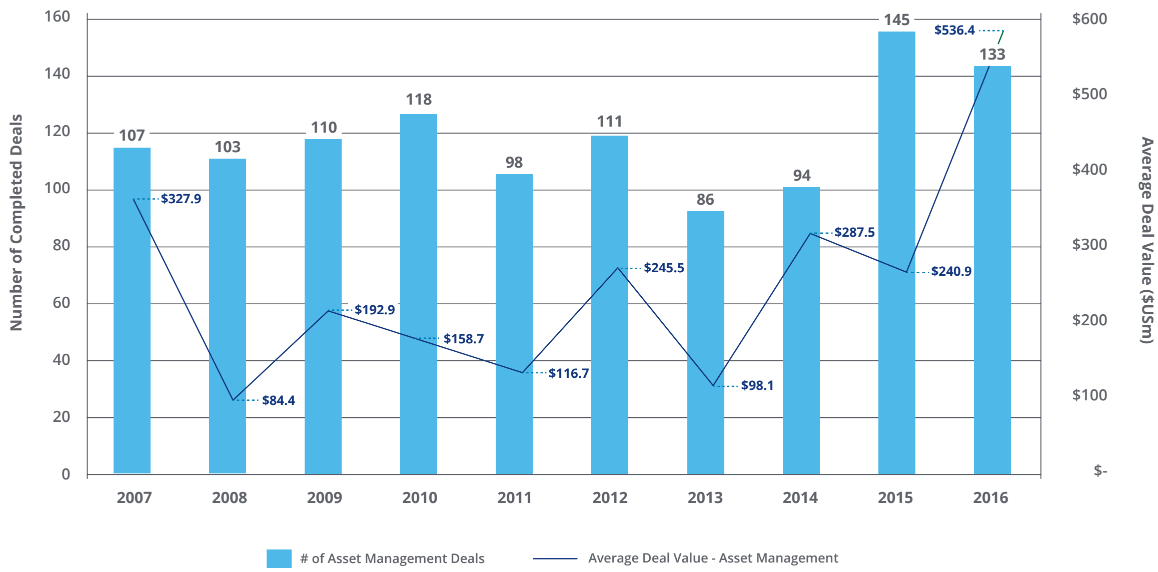
- **Transformative scale acquisitions**, driven by the quest for revenue and cost synergies that will help fund the infrastructure and operational changes necessary to compete. These deals will be larger, include more mergers of equals, and likely continue to be global.
- **Capability-based transactions**, mostly representing bolt-on additions of innovative investment products and technology solutions, either to meet investors' evolving service expectations or to tap new markets.
- **Deals that reflect a shifting value chain**, with many asset managers securing firms that extend their capabilities in direct distribution, wealth management, and other advice services to differentiate from competitors.
- **Pure consolidating deals**, structured to spread costs over a larger client asset base; several may take place in the US and European mutual fund marketplaces.

In this report, we review 2016 investment management M&A activity; share our expectations for 2017; and review selective trends and issues that have the potential to influence sector M&A in the coming year.

2016 in Review

As of December 31, the 2016 investment management (asset management & wealth management) M&A volume of 133 announced transactions was slightly lower than 2015's total of 145 deals but it was still a good year, particularly as average deal value increased from $240.9 million in 2015 to $536.4 million (Figure 3).

Figure 3: Asset & Wealth Management Transactions Worldwide



Source: SNL Financial and www.pionline.com

Note: Average deal size is based on disclosed deal values for asset and wealth managment transactions where 57%, 61%, 66%, 63%, 68%, 70%, 71%, 73%, 79%, and 81% of reported deals did not disclose deal values for 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015 and 2016 respectively.

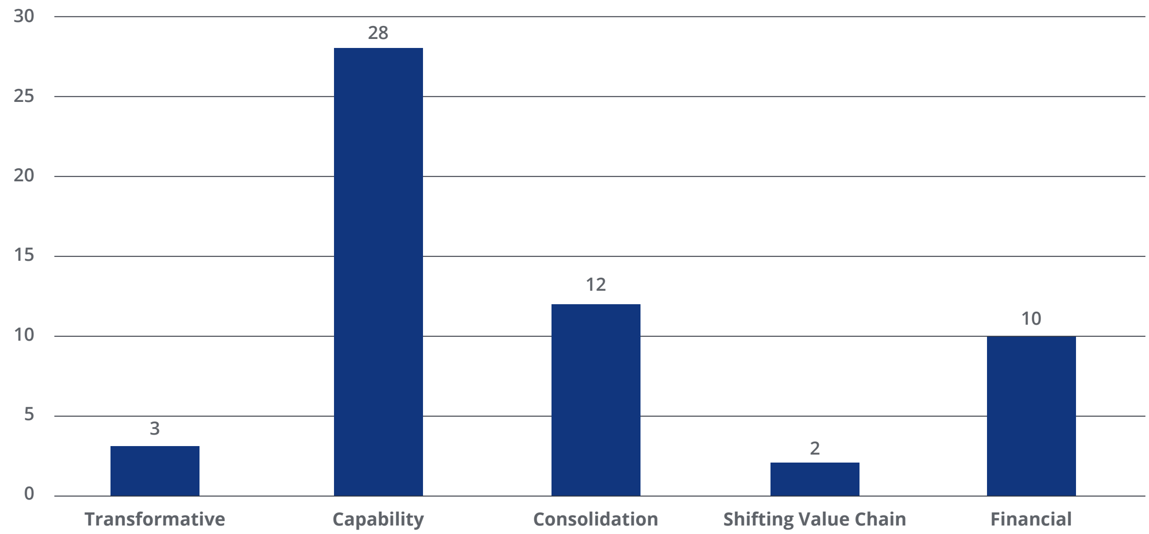
Grouping 2016's more significant deals by transaction type reveals some interesting macro-level trends:

Within asset management, transactions in 2016 tended to have at least one of five objectives (Figure 4):

- **Securing access to new capabilities**, be it additional, more innovative investment strategies, or access to new market segments
- **Continued globalization**, primarily by finding ways to unite existing distribution networks across the US, EMEA and Asia-Pacific
- **Cost synergies**, increasingly cited as a core deal motivator
- **Financial sponsor exits**, as private equity investors take advantage of rising multiples paid by a growing number of strategic buyers

Multi-affiliate firms remained active buyers, albeit more discriminating and strategic, focusing on new investment capabilities that would modernize their product arrays. Increasingly, multi-affiliate firms may rely on strategy more than simple financial engineering to drive value. They also may start to fund larger transactions by reorganizing their existing affiliate structures to find further efficiencies and build globally recognized brands.

Figure 4: 2016 Asset Management M&A Transactions Worldwide by Category



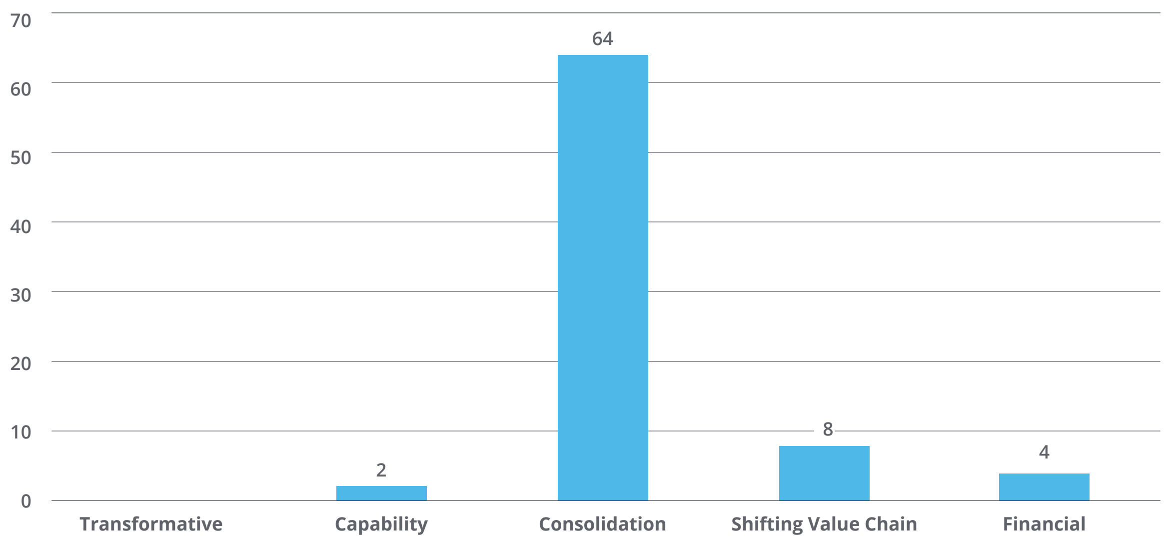
Source: SNL Financial, P&I Online, Casey Quirk Analysis and Deloitte Analysis

During 2016, a need for succession planning and liquidity drove a number of transactions among US wealth managers, as many US financial advisors reached retirement age. But several secular, more strategic trends also spurred deals (Figure 5):

- Consolidation, as various smaller wealth managers sought to improve profitability through economies of scale
- Expected activation of the Department of Labor's (DOL) fiduciary rule, which is anticipated to raise compliance costs on smaller wealth managers
- Access to new technologies and processes, not only to secure efficiencies but also as a response to the improved customer experience promised by increasingly prevalent robo-advisors
- A drive to access a wider range of clients, as Registered Investment Advisors (RIAs) in different geographies merged their books of business
- Bank and insurer interest, as some financial services companies secured wealth management skills to offer existing clients

A number of financial advisory networks, backed by private equity in many cases, continued to roll up smaller RIA networks, a trend that likely will continue in 2017.

Figure 5: 2016 Wealth Management M&A Transactions Worldwide by Category



Source: SNL Financial, P&I Online, Casey Quirk Analysis and Deloitte Analysis

Expectations for 2017

Investment management M&A activity should continue to be brisk in 2017. Aging population demographics are affecting industry asset levels and flows. In addition, the broad shift to passive management is putting pressure on industry fee levels and placing greater value on players with strong distribution platforms, as well as those which have invested in technology infrastructure to drive back-office cost efficiencies.

Private equity firms will become less active buyers, and potentially more active sellers, taking advantage of a growing number of strategic buyers with open checkbooks. Financial sponsors will continue to target growth stories such as wealth management rollups and consolidators, as well as financial technology plays that focus on asset and wealth management. Less likely will be the financial engineering transactions that defined most of the last decade—deals designed primarily to create founder liquidity or take advantage of an arbitrage in public-private multiples.

Casey Quirk cites four catalysts that are changing the investment management competitive landscape and fueling M&A activity in 2017:

1. Economic pressure. Deteriorating economics in the operating environment are pushing asset managers towards significant change:

- ***Deflating capital markets returns compared to the past 30 years***, as post-World War II GDP growth starts to slow on a secular basis, and interest rates remain low by historical standards; for an industry where revenues are fueled by asset growth, this is clearly a headwind.
- ***Slowing organic growth***, as asset managers have already tapped most conventional sources of new business for the industry. Additionally, pension funds are shrinking as they begin to pay benefits to aging baby boomers, many sovereign funds have started to spend their accumulated assets on policy initiatives, and more asset owners worldwide are electing to manage their own money.
- ***Shrinking profit margins***, with declining asset levels placing pressure on revenues, and fixed costs remaining inflexible, or even rising in places, as maturing asset managers deal with the increased systems and infrastructure needs of larger, maturing businesses.
- ***Fee pressure***, accelerated as investors push into lower-cost indexed portfolios; many active asset managers, struggling to prove their value to customers, increasingly have resorted to discounting. By 2020, the expected average all-in advice and portfolio management costs for a US retail investor will likely need to shrink if investors expect to maintain roughly consistent yields on their investments.

2. Distributor consolidation. The number of advisor decision-makers is decreasing and buying power is consolidating as distributors want their manager relationships to be fewer–and deeper. This is applying further pressure on the investment management industry. Drivers of intermediary consolidation include:

- ***Policy pressure,*** as regulators worldwide continue to lay more consumer protection and higher fiduciary standards on intermediaries, raising compliance costs beyond the tolerance of smaller organizations.
- ***Advisor retirement,*** as many financial advisors retire, leading smaller advisory firms to seek liquidity for departing founders and larger intermediaries to explore replacing human advisors with technology.
- ***Ongoing profit pressure***, making consolidation synergies more attractive, if still elusive, in many cases.

As distributors consolidate, they will seek larger, broader relationships with fewer investment managers, and favor providers with well-known and respected brand names –all in an effort to capitalize on pricing power and reduce compliance risk.

3. Need for new capabilities. As fee pressure rises and passive substitutes appear more attractive, especially to outcome-oriented individual investors, most active asset managers will need to provide more differentiated products in order to maintain current fee levels. Product development will continue to focus on:

- ***Multi-asset portfolios and strategies*** that are more outcome-oriented and built to adjust to changing market conditions.
- ***Illiquid strategies*** that provide less correlated returns to public markets.
- ***Next-generation fixed income skills*** around private debt, credit, and emerging markets and global capabilities.
- ***Highly differentiated equity strategies*** that are more concentrated and less benchmark-tracking in nature.
- ***Quantitative and systematic products*** that can meet cost-conscious consumer demands for smaller doses of alpha at lower fees.

Expanding distribution capabilities and tapping new markets also will drive strategic thinking in corporate development. Focus areas include access to faster-growing markets such as those in Asia-Pacific and skills for newer segments, such as outsourced CIO and insurance outsourcing.

4. Shifting value chain. As individual demands for outcomes become a driving force in the industry, investment management M&A transactions will reflect combinations of products and services designed to support more holistic advice. Likely deals will include:

- ***Insurers and wealth managers combining forces*** to blend insurance and asset management products in portfolios built around providing steadier sources of income and cash flow.
- ***Asset managers seeking wealth managers*** to integrate better portfolio allocation skills into more direct relationships with customers.
- ***Both asset managers and intermediaries acquiring robo-advice technology*** to gain direct distribution, value-added services for advisors, and efficiencies in servicing small accounts.
- ***Defined Contribution (DC) record-keepers being bought and sold***, as both intermediaries and asset managers explore tapping a growing pool of DC assets, particularly if policy begins to enforce regulations discouraging rollover.

Additionally, asset managers and wealth managers will make acquisitions related to securing, and better using, market and client data. Financial planning tools, vendors with distinct data, and financial technology vendors able to parse that information will become acquisition targets for investment managers.

Post Transaction Growth Strategies

These catalysts and others are driving asset managers toward M&A-focused inorganic growth engines that aim to secure competitive advantage in three ways:

1. Create revenue and cost synergies that fund transformative initiatives. Buyers and sellers are seeking transactions that either generate enough growth or reduce enough costs to permit greater reinvestment in their businesses. Synergies will focus on:

- Creating scale efficiencies to reduce the fixed cost of delivering products and services
- Combining complementary skill sets to improve competitive positioning, ejecting weaker business lines where overlap exists
- Pooling capital to fund broader, more transformative initiatives and outspend rivals
- Generating higher margins that either attract stronger shareholders or enable price reductions that appeal to customers and freeze out weaker competitors

2. Leverage data and technology to drive competitive advantage. Real-time, flexible access to data will advantage firms, through deeper client insights, to deliver a more tailored client experience, identify new alpha sources, and deliver sophisticated investment know-how at lower costs. Many deals will center on targets with access to unique data sources and technologies that can drive differentiated investment capabilities and client experiences:

- Automated advice, which encourages a more direct end-user engagement and changes the overall customer experience
- Enterprise data management, including cloud technology and less structured, network-driven databases, allowing firms to use data more effectively in decision-making
- Improved analytics, allowing more effective segmentation and more predictive capabilities
- Blockchain and similar technologies that remove redundant layers in overly complex series of transactions

3. Respond to fiduciary-based regulatory change. Most financial industry regulators worldwide continue to strengthen existing and/or propose new rules that add requirements to distributors of investment management advice and products, spurring some firms to shed assets and intermediaries to consolidate.

Smart Next Steps

Investment management organizations that are considering M&A in 2017—especially those that have been sitting on the sidelines—will need to develop a clear strategic vision to identify synergy opportunities and drive all key M&A lifecycle decisions (Figure 6). Success will require not only a strong emphasis on strategy, but also on transaction services. It will be critical for buyers to accurately price expected growth and risk, particularly regarding cost savings. Financial and commercial due diligence is essential, along with well-planned post-merger integration, with an eye toward securing competitive advantage.

Figure 6: M&A Lifecycle

M&A strategy

- Strategic planning
- Value proposition definition
- Future-state vision
- Synergy estimates
- Business case
- Portfolio strategy
- Competitive assessment

Transaction readiness

- Target screening
- Readiness review
- Due diligence
- Separation structuring
- Value identification

Transaction & diligence + execution

- Deal structuring
- Bid and negotiation support
- Investment capability diligence
- Competitive due diligence
- Financial due diligence

Closing & integration strategy

- Integration planning
- Incentives
- Communications
- Integration project management
- Sale purchase, financial, advisory agreement
- Purchase price allocation

Post-close transition integration + transformation

- Integration office
- Day 1 readiness
- Implementation plan
- Transition services agreement
- Stranded-cost management

Developing an M&A playbook is another valuable exercise because it allows firms to devise several marketplace scenarios and model their potential responses. The landscape is likely to change in 2017—especially on the regulatory front. Compiling, analyzing, and leveraging accurate and up-to-date news and information should anchor strategic M&A planning and execution.

Serial acquisitions left largely unchanged over time will likely fail to provide the revenue and cost benefits required for asset management firms to remain competitive. Buyers and sellers will need to invest more time and resources in integration planning and execution, particularly around four key areas:

- Competitive investments and distribution organizations, appropriately resourced and centered on capabilities and client segments where the combined firm has clear competitive advantage.
- Effective incentive alignment programs that reinforce enterprise-wide strategic objectives and allow talent to share in the growth of franchise value.
- Brand and firm positioning built on attributes that not only underscore the firm's competitive advantage, but also incorporate elements of fiduciary responsibility and investor trust.
- Streamlined operating models that promote cost efficiency as well as ease onboarding of new capabilities and talent, making further acquisitions more effective from day one.

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