CHESTNUT ADVISORY GROUP

Investment Industry M&A: Bigger Is Not Necessarily Better

IN THIS ARTICLE

M&A among investment firms is a strategy intended to drive profitable growth. We examine the trends motivating these deals and the many hurdles to successful deal execution.

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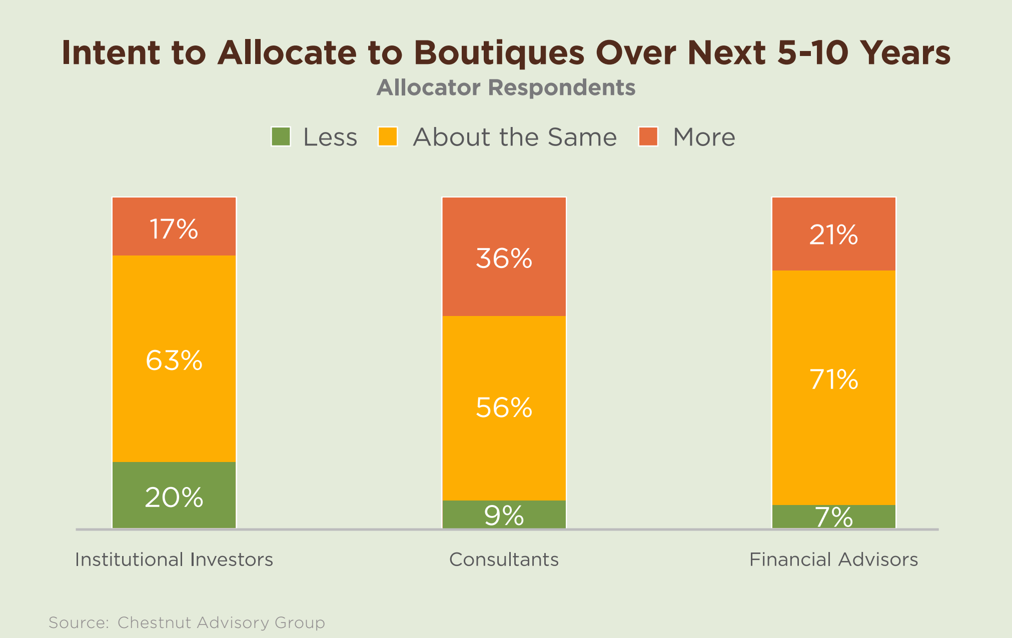
Chestnut Advisory Group is a boutique growth strategy consultant dedicated to asset managers and OCIOs. We provide custom advisory services on product, distribution, M&A and brand strategies. Chestnut is a woman-owned, practitioner-led firm.

Successful scale-seeking M&A transactions are rare. We believe a growth strategy centered on scale can only be effective for a select few investment firms that can combine scale-driven low-fee offerings with differentiated product(s) or service(s) that address key investor needs. Most investment firm scale-seeking mergers do not meet these criteria.

Deals aiming to deliver new and differentiated benefits to investors can work well. We call these 'boutique advantage' deals. Allocators view the boutique segment as a good place to find firms offering key benefits investors seek from their managers: differentiated risk/return streams, deep expertise and insights, customized products, and strong client support. Unsurprisingly, allocators say they plan to continue investing in boutique managers (see chart below).

Investment firm M&A deals face a unique set of strategic hurdles that must be thoughtfully addressed in order for the post-deal firm to successfully grow. Without a thoughtful merger integration plan, projected cost savings often prove to be a mirage, while newly acquired products and services fail to be adopted by the acquiring firm's target clients.



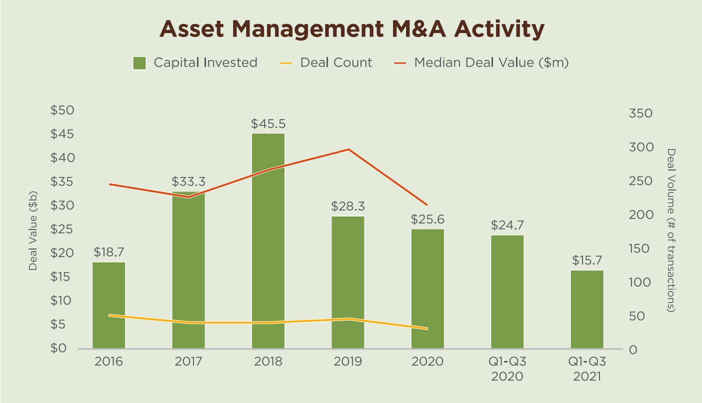
Investment Industry M&A: Bigger Is Not Necessarily Better

In our strategic growth engagements with asset managers and OCIOs we often analyze acquisitions and divestitures. Between our client work and the authors' own pre-Chestnut careers, we have personally been involved in a wide range of investment M&A transactions. In this article we examine key industry trends driving most current M&A activity and discuss the many hurdles to success faced by investment managers seeking growth via M&A.

This article is part of our Future of Investments research project, incorporating research results from over 450 investment professionals in four key cohorts: asset managers, institutional investors, RIAs and investment consultants.

Substantial Investment M&A Activity Continues

While the volume of asset manager deals is a bit lumpy, strategic M&A activity across the investment management industry continues to be a widely-considered growth strategy.

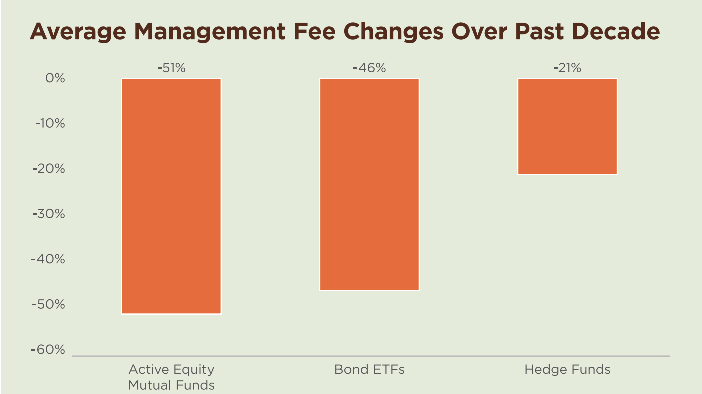


Source: Pitchbook. Includes asset and wealth-managers.

We put asset manager M&A transactions in two broad strategic categories: scale-seeking transformational transactions; and 'boutique advantage' deals aiming to bring complementary and ideally incremental product and service extensions to the acquiring firm. Each transaction type is a response to major industry trends that show no signs of slowing: declining fees and investor preferences for boutique-like products and services from their managers.

Declining Fees Drive Scale-Seeking Deals - But Do They Deliver?

It is old news that investment management fees have been steadily declining for over a decade. The reasons for this trend have been well-examined, and we absolutely expect fee declines to continue. The large magnitude of these fee declines - upwards of 50% in some cases - is, we believe, the primary driver of what we call 'scale-seeking' asset manager M&A transactions.



Source: Piper Sandler, ICI, EurekaHedge, Preqin
Note: Equity and Bond data 2010-2019; Hedge fund data 2009-2019

Our experience is that the 'scale-seeking' investment firm acquisition thesis proves to be a mirage in most cases. One asset manager research participant told us, "70% of asset manager M&A is a waste of time." We agree with the sentiment.

We believe a growth strategy centered on scale can only be effective for a select few investment firms that can combine scale-driven low-fee offerings with differentiated product(s) or service(s) addressing key needs of the combined firms' target investors. Most investment firm 'scale-seeking' mergers do not meet these criteria.

At Best, Acquisition-Derived Scale Only Provides Temporary Margin Protection

Fee declines pressure asset managers' profit margins. Efficiency-seeking asset manager strategic operating changes (such as moving data to the cloud, outsourcing back and middle office services where possible, consolidating vendors, etc.) can and have helped cut costs to maintain fairly healthy operating margins. Nonetheless, the idea of a scale-oriented transformational acquisition that could more permanently improve operating margins of the combined entity can seem attractive and tempting.

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Cutting Costs Without Damaging the Business Is Difficult

In almost all the investment industry M&A we have participated in and closely observed, we have found the realized cost savings end up not only smaller than those originally projected, but these savings are often fleeting. The primary reason for this persistent cost disappointment, in our view, is that at an asset management or OCIO firm undergoing M&A integration, the costs these firms are aiming to cut invariably impact the people who touch the firm's clients and produce the firm's products.

The pre-deal intent is usually to disrupt client-facing people as little as possible, as merging investment firms generally focus on cutting middle and back-office costs such as legal, operations and compliance. On paper, the people working in these areas generally don't handle client relationships or investment decisions. As a result, those building the combined entity's financial projections generally assume that the rest of the firms' operations will experience only modest impact before allowing all the operating savings to fall to the bottom line.

In practice, however, all parts of an investment firm involved in a scale-seeking merger are affected. This widespread impact usually causes the operations integration to take longer and cost more than expected.

Scale Does Not Give Asset Managers Pricing Power

As our fee decline data demonstrates, asset managers are essentially unable to raise their management fees today. The best pricing outcome for a scale-seeking asset manager transaction, in our experience, is that the resulting combined entity is able to temporarily maintain pre-deal pricing on its most differentiated products. In several of the largest asset manager scale-seeking deals the resulting combined firm used its scale to proactively lower the firm's fees as a strategic move to gain market share.

Deals Aiming to Deliver Boutiques' Edge Can Work Well

Allocators view the boutique segment as a good place to find firms offering key benefits investors seek from their managers: differentiated risk/return streams, deep expertise and insights, customized products, and strong client support. Unsurprisingly, the overwhelming majority of allocators participating in our research indicate they plan to continue investing as much or more capital with boutique managers as they currently do over the next five to ten years (see chart on cover page).

In our experience, the most successful asset manager M&A transactions are those designed to bring what we call a 'boutique advantage' to the post-deal firm. These successful 'boutique advantage' transactions have two things in common:

- The acquirer gains a capability (product, service or both) that its clients need and the firm did not already have.

- The acquired firm's assets (products/services, culture, people) fit well with the buyer's brand, target investor market segment(s), and culture.

Boutiques are an important segment contributing to the overall health of the asset management industry, and we do not expect it to shrink or disappear. We believe this survey respondent got it right when they told us, "On the one hand, niche expertise should gain assets due to the desire for differentiated alpha. On the other hand, the regulatory cost burden keeps growing, making it harder for small firms to remain viable. Given the balance of opposing forces, I think it evens out."

> We believe 'boutique advantage' acquisitions can create huge value for all constituents, with one big caveat: the transaction must be well-executed.

Asset Managers Are Bearish on Boutiques' Outlook

Most asset managers substantially underestimate the ongoing demand for allocating to boutiques. Almost 40% of asset manager survey participants expect allocations to boutiques to decline over the next five to ten years, a huge contrast to the small 9% of consultant respondents with the same bearish outlook.

This widespread and mistaken expectation that the boutique manager segment will shrink is not irrational. Manager league tables continue to show the biggest asset managers receiving the bulk of the asset flows. Nonetheless, the belief that, as one asset manager survey respondent put it, "Boutiques are struggling to compete because they can't provide the transparency of reporting investors demand" is mistaken, in our view. Well-run boutiques will continue to thrive by offering products and services investors want. This is exactly why we believe 'boutique advantage' acquisitions can create huge value for all constituents, with one big caveat: the transaction must be well-executed.

A Wide Range of Acquired Investment Products and Services Can Be Accretive

Asset managers with a good understanding of their target investors' needs can enhance their growth trajectory via acquisitions that enable the acquirer to better meet those needs. The most common type of 'boutique advantage' acquisitions are those bringing the acquirer new products (lately the focus has been on buying alternative asset class and ESG capabilities), product-enhancing technology (particularly relevant for OCIO providers today) or middle and back-office technology.

Transactions providing the buyer access to new markets (geographic or client segment) can also work well, as long as the target investors in those new markets have needs that the acquirer is well-positioned to meet with a differentiated offering. In many new market deals, unfortunately, the new market investor's preferences are not verified (ideally via custom market research) ahead of time, which usually leads to a disappointing outcome.

Key Elements of Successful 'Boutique Advantage' Deals

While no asset manager M&A transaction will succeed without careful execution of a thoughtful integration plan, there are two additional elements that successful 'boutique advantage' deals have in common. First, the boutique's products and services actually address known needs of the acquirer's core clients. Second, the boutique is what we call 'acquisition-ready'.

An acquisition-ready boutique is one where the firm's team has widely acknowledged and accepted the need for an ownership change to achieve the firm's strategic growth goals. A key piece of this readiness is a thoughtful leadership transition plan. Ideally, as we discuss below, the next generation of leadership retains equity ownership as an incentive.

Selling a Boutique Without Damaging It Is Challenging

The most common exit strategy for asset manager founders remains selling their firm in some form. Allocators expect most of these deals to fail. As one consultant survey respondent told us, a head of research at a major consulting firm found that only 1 of 65 asset manager M&A transactions benefitted clients. The rest "inevitably led to adverse changes at the acquired manager as people's roles changed and people left. And that is the norm."

In our experience, the success rate of boutique M&A involving a full sale of the firm remains low today. In addition to a boutique being acquisition-ready, other common factors among those successes are maintaining firm culture, a beneficial match between the boutique's target investors and the acquirer's distribution capabilities, and a focused brand and distribution strategy.

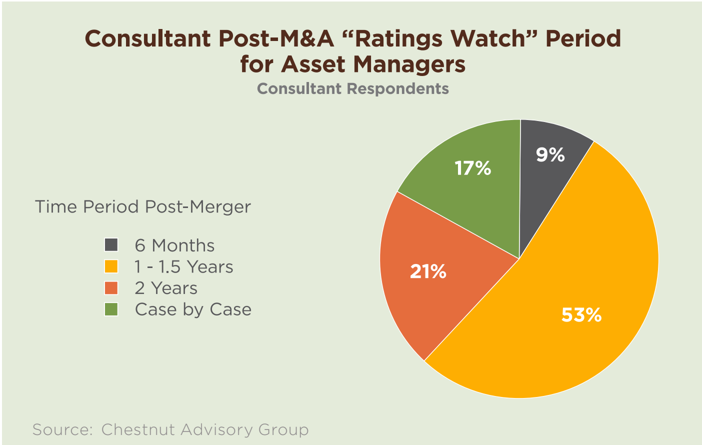
Partial-Stake Boutique Sales Tend to Fare Better

A new group of private equity investors aiming to buy partial stakes in asset manager boutiques has emerged over the past decade. In most of these transactions the pre-deal owners and investment teams retain an ownership interest that keeps their interests aligned with investors and provides an incentive to the next leadership generation to remain at the boutique.

Common Hurdles to Achieving Synergies in Investment Firm M&A Transactions

We have found again and again that the magnitude and length of the business disruption caused by asset manager acquisitions are almost always underestimated by the firms involved.

This disruption is the result of stumbles over several common hurdles we believe block successful investment manager M&A transactions. These hurdles, taken together, are the primary reason investment consultants tell us they automatically put asset managers involved in M&A transactions on 'ratings watch' for one year on average.



Culture Clashes Can be Deadly

The heart of every successful asset manager, in our view, is a successful firm culture. We have conducted substantial research all pointing to firm culture and investment philosophy as the primary drivers of investor decisions to hire an asset manager. As one investment consultant research participant told us, "Culture can be a big reason not to do an asset manager deal."

Culture issues are a primary hurdle to talent retention post-transaction, and investment talent departures are generally an automatic trigger for eventual client redemptions.

Cases where asset manager firm culture impedes post-M&A cost-cutting are widespread. In one scale-seeking merger we were involved in, each predecessor firm had such a strong and successful culture that merging the two into one became a herculean task. While there were many other challenges to this deal, we believe culture was the primary reason that a full decade after the deal closed, external clients and vendors, as well as internal employees, would refer to working with either the pre-merger Firm A or Firm B side. Needless to say, the projected cost-saving synergies never materialized.

The same culture and talent issue applies to consultant M&A transactions. As one endowment Board member research participant told us, "Lots of talent leaves after a consultant acquisition, and that hurts the clients."

> "Culture can be a big reason not to do an asset manager deal."
>
> - Investment Consultant

Poor Product Discipline

Most scale-seeking mergers of firms with similar legacy products plan to combine or eliminate many of the overlapping products. This product rationalization plan is often exceedingly difficult to execute.

As an example, consider two firms engaging in a scale-seeking merger. Each pre-deal firm has substantial suites of long-only equity and fixed income products, with most of the AUM tied to longstanding investor relationships. Most of the legacy products overlap. Once the deal closes, investment teams, consultants and even clients begin lobbying the firm to keep existing products in place. As a result, the firm takes too long (upwards of a year or more) to determine which products will remain and which will close. During this 'strategic product review period' the firm lacks a thoughtful, fiduciary-oriented approach to proactively shepherd its clients to the surviving products.

Unfocused Distribution and Marketing Strategy

In our experience there is a high correlation between merged firms with an undisciplined approach to product rationalization and those with an unfocused go-to-market strategy.

In scale-seeking deals, post-merger distribution and marketing teams are commonly asked to prioritize client retention with a message of continuity for now and changes to be announced. Often there is a lack of consensus around product and message prioritization, primarily due to a lack of a clear post-merger growth strategy at the top of the firm. The resulting mixed message in the marketplace raises investor concern and leads to a loss of trust and eventually a loss of investor capital.

In 'boutique advantage' transactions, a 'multi-boutique' strategy has been adopted by many large firms over the past two decades. In some cases, this approach is now being unwound. Although the idea is good on paper (the acquiring firm keeps the seller's brand and often also agrees to keep the boutique's marketing and distribution teams intact), in practice the multiple messages, teams and brands often end up stepping on each other, hurting the firm's go-to-market approach.

Increasingly in boutique acquisitions, the acquirer's distribution team (typically much bigger than the boutique's and enjoying strong relationships with major allocators and consultants) is expected to sell more of the new boutique's products than the boutique could on their own. Unfortunately, this happy outcome often does not occur. As previously discussed, investors are highly skeptical about these deals, and consultants automatically put deal-related firms on 'ratings watch'.

In addition, the allocator decision-makers for traditional and alternative products are increasingly completely different teams of people. In order for the boutique's products to be effectively sold by the new parent's distribution team, new client relationships, in-depth product knowledge and an understanding of the boutique's target client needs must be built. Often new distribution professionals must be added, and substantial training of existing distribution teams must be completed. Without these steps, investors will quickly question the firm's credibility.

Technology-Driven Cost Savings Are Often Overpromised and Underdelivered

An investment analyst's truism is that any projected M&A cost savings tied to technology should be haircut by at least 50% and the time to realization should be doubled. In our experience this truism also applies to investment firms, particularly those involved in scale-seeking deals. We have observed that the monetary value of tech-driven 'time savings' are often never realized, for two reasons.

The staff reduction opportunity is smaller than planned or skipped altogether, and the opportunity to reinvest the impacted staff's time in more value-add activities is not successfully achieved, if it is attempted at all.

Uncertainty Itself Is a Cost

Investors dislike change, particularly among the people who are managing their capital. In a scale-seeking merger, every employee at both firms is impacted. As a result, each firm's relationships with all existing clients and consultants are immediately disrupted, with the manager placed in the penalty box for a year on average.

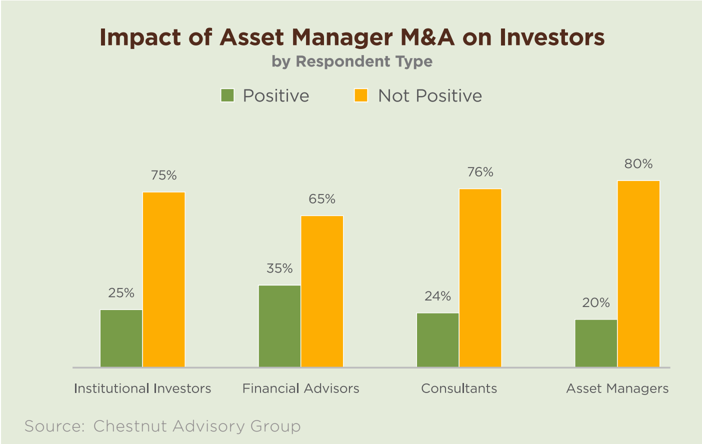
At best the post-merger firm will have a strategic plan that effectively assuages these concerns, but in almost every case unexpected changes raise this 'uncertainty cost.' As one large asset manager research participant told us, "There will always be a period of disruption, so the question is whether that ultimately results in a better organization or not."

Make a Plan to Overcome M&A Obstacles BEFORE the Deal Closes

Merging investment firms who have successfully minimized or avoided the common obstacles discussed above all have a well-designed strategic plan providing a transparent roadmap so all constituents can track success. This intentional journey must be communicated clearly and often to everyone involved. As we discuss below, there is a wide range of constituents impacted by asset manager M&A.

Impact of Investment Manager M&A: A Mixed Bag

Industry sentiment for investment firm M&A has been negative for some time, and our recent survey data certainly confirms that bearish sentiment is alive and well today. Over 75% of investors, consultants, and asset manager participants in our latest research each rated the impact of asset manager M&A on investors as negative.



Investors are one of several constituencies impacted by asset manager M&A. Below we examine the common impact of asset manager M&A on each group.

Investors Do Not Like Asset Manager or Consultant M&A

Delivering better products and services to the firm's investor clients is almost always a key stated rationale for asset manager and consulting firm M&A transactions. Nonetheless, our research shows investors overwhelmingly believe they are hurt by these transactions, not helped. Investment consultants, RIAs and asset managers themselves all agree on this point. We see several reasons for this widespread view that asset manager M&A hurts investors.

There are negative investor impacts of asset manager M&A which almost always occur, while investor benefits accrue over a much longer period, if at all. For example, it is a certainty that at least some of the firm's clients will experience additional work as a result of the deal (this expands to essentially all the firm's clients in scale-seeking transformative transactions). As one investor survey participant told us, "When asset managers merge this can cause all sorts of extra work for the clients: paperwork (new IMAs), due diligence, perhaps searches. Mergers…in the short term can be hard on clients."

In cases where the expected client benefits are ultimately delivered, this occurs gradually over several years after the deal has closed and the investors have already completed the extra work necessitated by the deal. In other cases, the deal's benefits do not directly impact clients. Either way, net investor impact is viewed as negative. As one consultant research participant told us, "Sometimes asset manager M&A can enable the firm to keep doing what it does best while offloading other things. But until that becomes clear, an acquisition muddies the water and requires that you question your confidence in the strategy. And of course, they might blow up the culture."

For both asset managers and consulting firms aiming to retain clients after a strategic transaction, the approach we recommend to alleviate these investor concerns is a clearly communicated M&A integration strategy making future changes as anticipated and transparent as possible. As the M&A benefits begin to accrue, the manager or consultant must remind the marketplace that these benefits are the result of the acquisition(s).

Consultants Dislike Asset Manager M&A…

Investment consultants, arguably asset managers' most influential constituency, generally approach asset manager M&A with a 'guilty until proven innocent' mentality. As discussed previously, managers can expect to be placed on consultant watch lists for 12-18 months post transaction on average. This activity has certainly kept consultant research teams well-engaged over the past decade. As one investment consultant research participant told us, "If asset manager M&A stopped, manager research teams would have lots of time on their hands."

> When asset managers merge this can cause all sorts of extra work for the clients: paperwork (new IMAs), due diligence, perhaps searches.
>
> - Institutional Investor

…and Asset Managers Dislike Consultant M&A

With fewer consultants and the ascendance of consultant OCIO practices, asset managers view investment consultant consolidation with a wary eye. The first concern is that bigger consultants will manifest more fee negotiation leverage. Concern also exists regarding shelf space. The view is that with less consultants, there will be fewer eyes to rate emerging and existing strategies, thereby elongating time taken and lessening the possibility of ever attaining that elusive "buy rating" asset managers all seek.

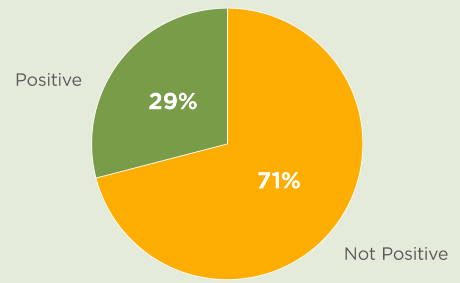
M&A Impact on Employees Is Never Neutral

Every employee of an investment firm involved in an M&A transaction will be impacted. In our experience, top talent almost always benefits from industry M&A. Where the culture fit is well-managed, top talent stays and thrives. In cases of a culture clash, opportunities for the best performers always appear. For the rest of the firm the impact varies but is never neutral.

Seller Equity Owners: Clear Short-Term Winners

Founders monetizing their ownership stakes are usually clear winners upon the deal's close. After the close, however, retainer and non-compete agreements come under scrutiny. As discussed above, the incentives and commitment of the next generation of the firm's leaders are key to the ultimate success of the deal.

Impact of Investment Consultant M&A on Asset Managers
Asset Manager Respondents



Source: Chestnut Advisory Group

Buyer Equity Owners: Mixed Short-Term, Less Positive Longer-Term Impact

Publicly traded asset managers' stocks often decline near term on news of an acquisition. Nonetheless, acquisitions often provide interim relief for Boards under pressure to create change or to dispatch hostile activist investors. Over the longer-term, the minority of buyers who successfully achieve their deal goals reap the equity benefits, while most do not.

Conclusion: Why Bigger is Not Necessarily Better for Investment Firms

Although M&A is an appealing growth strategy for asset managers, over 75% of investors, consultants, and asset manager research participants rated the impact of asset manager M&A on investors as negative. To avoid this fate, we recommend investment firms create a well-designed strategic plan to address the following common hurdles to successful M&A deals.

Avoid Deadly Culture Clashes

As one investment consultant survey respondent told us, "Culture can be a big reason not to do deals." Culture issues are a primary hurdle to talent retention post-transaction, and investment talent departures are generally an automatic trigger for eventual client redemptions. Particularly in transactions involving the full or majority sale of a boutique firm, a clear line of sight to the next generation of leadership, coupled with financial incentives to retain those upcoming leaders, is crucial for the ultimate success of the transaction.

Identify Target Investors and Their Needs

We are continually surprised to see investment firms base their growth strategy, including M&A deals, on the 'if you build it they will come' philosophy. Without a clear definition of who 'they' is for the newly-combined firm, and a deep understanding of the 'it' the investment firm is hoping their target investors need, successful growth is unlikely to occur.

Establish Investor-Centric Guidelines to Ensure Product Discipline

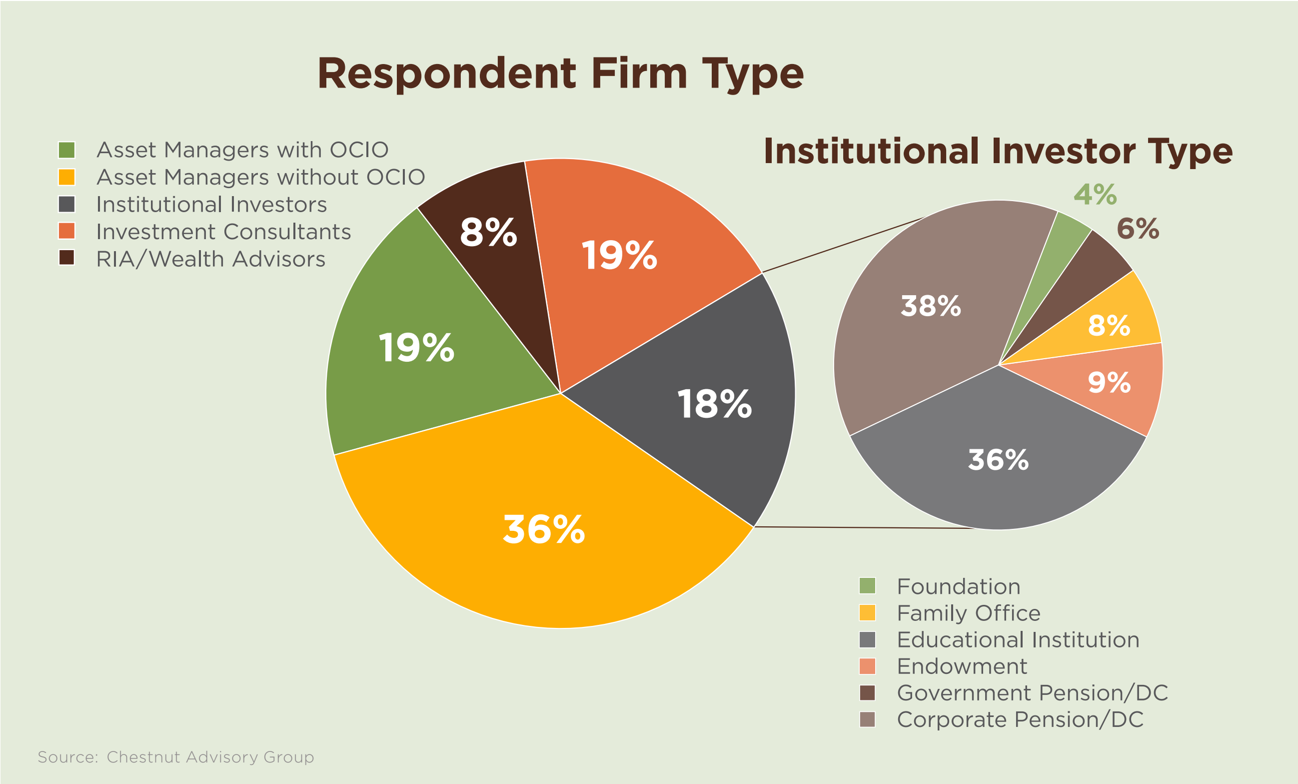
Periodic product lineup reviews and rationalization is a best practice for any investment firm, and a necessity for most firms involved in M&A transactions. When decisions regarding the firm's product lineup are driven primarily by target investors' needs, it is a relatively straightforward exercise to create a thoughtful, fiduciary-oriented approach to steer clients to the surviving products.

Communicate Early and Often with All Constituencies

A consistent communication effort keeping all impacted constituencies (clients, employees, partners, shareholders) informed about the deal's integration process is the most effective way to ensure the deal is ultimately viewed as a success. The broad merger integration plan should be shared at the outset, with regular updates on key milestones, particularly those that deliver any promised client benefits.

Research Methodology

As the investment industry faces unprecedented challenges, Chestnut Advisory Group and *Pensions & Investments* partnered to conduct comprehensive research into the issues impacting the future of the investment industry, your organization, and your career. Over 450 professionals from across the industry participated in our study.



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