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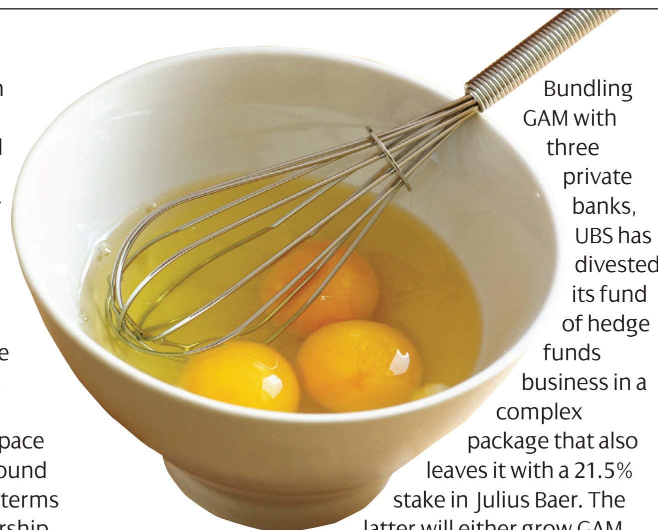
Finding the perfect mix

Over 65% of mergers and acquisitions fail because decision makers don't take the economics into account, says **Amin Rajan**



The latest data from Jefferies Putnam Lovell show record levels of M&A activity in the funds industry – in the number and size of deals – since 2004. Outwardly, they herald the arrival of the long awaited consolidation. But behind the numbers, things are not that straightforward.

Industries like auto, aerospace and pharmaceuticals took around 55 years to become global in terms of clients, markets and ownership. Fund management has achieved the same feat in a third of the time, save for one notable difference: the over-rapid growth has yet to produce a mature industry with expertise, resilience and the mindsets necessary to tackle the resulting complexity.

To make today's acquisitions work, you often need a slash and burn strategy whilst at the same time scaling up the assets. After acquisition, the whole must be worth more than the sum of the parts. This is the exception rather than the rule in numerous deals that I have studied over the last 15 years.

THREE MODELS FOR M&A

Three well-publicised cases show that there is more than one way to benefit from mergers and acquisitions.

The first of these covers the deal between UBS and Julius Baer. Bundling GAM with three private banks, UBS has divested its fund of hedge funds business in a complex package that also leaves it with a 21.5% stake in Julius Baer. The latter will either grow GAM through distribution synergy or streamline it – either way, UBS will continue to reap the benefits.

The second one is the landmark Citi-Legg Mason deal. It proves that manufacturing and distribution no longer have to be joined at the hip: they can be swapped within a complex alliance commonly seen in oil and auto industries.

> AFTER ACQUISITION, THE WHOLE MUST BE WORTH MORE THAN THE SUM OF THE PARTS

In the wake of regulatory brush-offs in the early part of this decade, Citi has eliminated perceived conflicts of interest in two bold strokes: moving research out of investment banking and manufacturing out of fund management; thus focussing on distribution and back office services.

This left Legg Mason with five challenges: how to streamline its vastly expanded product portfolio; how to create a boutique model that harnessed the talent of its front office teams; how to ensure that its renowned investment culture was not overly diluted by newcomers; how to integrate support functions; and how to maintain performance in the transitional phase.

Aberdeen Asset Management's acquisition of the Deutsche Asset Management's UK business was a third landmark deal: acquiring expertise rather than scale or market position; and linking the price to customer retention over a finite period.

It, too, faced formidable challenges in retaining and motivating the top fixed income managers at the centre of the acquisition. Leap frogging competitors in the league tables comes at a price, as does the buccaneering leadership style which served it well when it had £28bn in funds under management. Scale creates complexity where the old ways of doing things rarely work.

A NEW WEB OF ALIGNMENTS

Factors such as perceived conflicts of interest between manufacturing and distribution within bancassurance groups, and separation of alpha and beta, will continue to drive M&A activity over the rest of this decade.

This much is clear from a recent study*. While anticipating further mergers, it concludes that, for the foreseeable future, mergers will not

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polarize the industry between global scale players and nimble independent boutiques, squeezing out those in the middle. Instead, it projects two dominant trends.

The first one involves decoupling and regrouping around three core activities – manufacturing, distribution and administration – in response to changing client needs. The second trend involves the adoption of a hard-nosed horses-for-courses approach to business growth within each activity:

- in administration, characterised by low margin high volume business, economies of scale will remain a key goal
- in distribution, characterised by a shift from products to solutions, mass customisation will be the key imperative
- in manufacturing, dominated by skills-based consistent returns, economies of scope (covering an array of asset classes) will be the name of the game.

Not surprisingly, pursuit of scale has been a critical consideration in the deals involving administrators. Elsewhere, the story is different.

"Delivering good performance increasingly requires concentrated bets that can constrain capacity and burn a portfolio. Many of the transactions are between fund managers, seeking to enhance the scope of their product mix," says Ben Phillips, managing director and head of strategic analysis at Putnam Lovell.

The annual data on M&A deals compiled by Phillips over the last six years suggest greater specialisation in each of the three core activities. They also suggest ever more alliances between players in each of the distinct elements.

The business swap between Citi and Legg Mason in 2005 was a good example of specialisation. The headlong growth of multi-manager funds and back office outsourcing are good examples of alliances. They allow small and medium houses to flourish by focussing on their core investment strengths; thus amplifying the craft orientation at the manufacturing end. In many hedge funds businesses, for example, prime brokers and administrators are now becoming an integral part of the front office by participating in product innovation.

Hence, instead of polarisation, the industry is witnessing the emergence of a web of relationships between players who focus on their unique strengths within an ever more sophisticated supply chain. While M&As will continue, the result is hard to predict for two reasons.

First, mergers involving medium and large firms have created massive challenges in effective integration because of cultural differences, legacy arrangements and lack of required management bandwidth. It will be a long time before they achieve the targeted synergies. There is no shortage of economies of scale; there is a shortage of management will and ability to extract them.

AMIN'S ADVICE

Tips for CEOs, CIOs and COOs:

1. MORE ACQUISITIONS ARE DRIVEN BY EGOS THAN ECONOMICS:
that's why the failure rate is over 65%

2. IF YOU DECIDE TO DO AN M&A, MAKE SURE THERE ARE MINIMUM OVERLAPS:
slash & burn is very hard in a people business

3. THE IMMEDIATE AFTERMATH OF AN ACQUISITION IS CRUCIAL:
have a plan with clear metrics, time lines and accountability

4. NEVER HAVE CO-HEADS OF ANY FUNCTION:
they send out the wrong signals

5. WELL EXECUTED ACQUISITIONS DELIVER IMMEDIATE RESULTS:
if the targeted benefits are not there within a year, hit the panic button

Secondly, deals that target skills necessarily rely on a decentralised operating model that gives significant autonomy to the newly acquired units. But if and when their performance deteriorates, disillusionment sets in quickly due to the top dollar price tags. Greater central control is often imposed to the detriment of creativity and innovation.

Three of the biggest deals in the 1990s suffered this fate: Scudder Investments acquired by Zurich Insurance and re-sold to Deutsche Bank; Gartmore Investments was acquired by Nationwide Mutual Life and re-sold in a management buy-out; and Mercury Asset Management acquired by Merrill Lynch and resold to BlackRock.

These and numerous other divestments underline a simple point: globalisation is changing the business contours but fund management still remains a cottage industry. It will take a lot of burn and churn before we see significant consolidation. **TFB**

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CASE STUDY: OF A MANAGER WHO DID MULTIPLE MERGERS

"Our former CEO so loathed any form of centralisation that he even ran a 'virtual' head office. Central functions were dispersed around the world to suit the personal circumstances of the members of our Exco and their direct reports. The structure was built around these individuals who joined the group as a part of series of acquisitions in the late '90s. We went from a single location in the US to around 40 in 21 countries in less than ten years. Yet, as recently as three years ago, there was no integration.

Each business had its own board, P&L, and compliance, with no integration of front, middle or back offices. But the argument at the time was that this operating model was hugely conducive to attracting, retaining and deploying talent. Nobody thought about operating leverage, so long as the bottom line looked healthy.

The only time that senior managers below the Exco level communicated was over disputes when products manufactured in one business were distributed by sister businesses under a global revenue sharing formula. The formula was honoured more in the breach than in the observance, sapping physical and emotional energy within a culture of excessive individualism."