Adversity creates opportunity

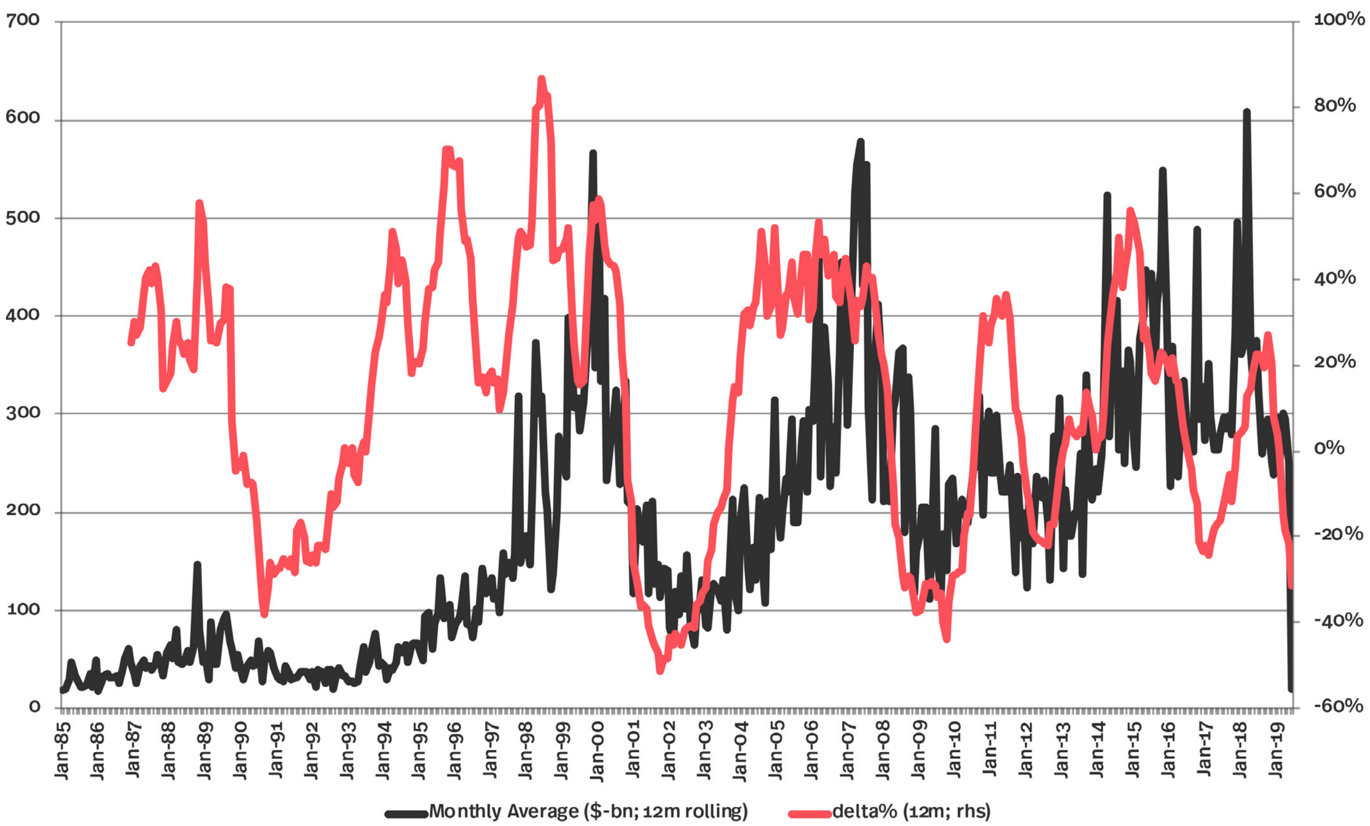
The drive to consolidation has been part of the narrative for asset managers over the last few years, driven by the need to diversify the portfolio to counter competition both from new tech entrants and more niche/agile asset managers, or simply to fill a gap in the portfolio. The pandemic provides additional challenges but also an opportunity for the industry to look at tactical acquisitions as well as address some of the more long term operational efficiency issues through more strategic options. Here we take a look at some of the drivers and constraints for M&A in the sector and offer the industry with some insights into why M&A will continue to play a role as we navigate through these opportunistic times.

Key Points

- Anecdotal evidence points to a recent uptick in M&A activity in the asset management sector
- That's consistent with our analysis of previous crises
- Sustainable upturn possible from Q3/Q4 including for estimated $2.5trillion of dry powder
- Current margin/ cash-flow pressure increases risks of insolvency and likely therefore reinforces those trends
- Country/ sector themes may include a secular shift to Asia/China and ESG/ fintech/ quant and democratisation of assets
- Greatest risk factor: second wave
- Brexit looms with 40% chance of no FTA/ no extension/ WTO

Chart 1: M&A Cycles - COVID closing in on GFC and 'Tech-Wreck'

Source: The Institute for Mergers, Acquisitions and Alliances (IMAA); Simmons & Simmons



What we're seeing - current activity

M&A activity may recover sooner than expected. Our specialist asset management M&A team have seen an increase in activity. In particular, they have been instructed on or have started discussing multiple M&A deals since lockdown – these are asset managers buying asset managers. The drivers behind these deals include succession, consolidation, filling portfolio and skill gaps and extending geographical reach.

Whilst there was an initial deal pause immediately into lockdown, the market seemed to quite quickly adjust in a few weeks and there has been an uptick in new and prospective deals. The adjustment to delivering deals remotely - video calls, virtual meetings and virtual diligence, e-signing platforms (etc) – presented fewer challenges than one might have expected, and common deal third parties, such as W&I insurance providers, quickly came up with new products and approaches to deal with the new landscape. Of course, deal terms seem also to be adjusting to reflect the "new normal" (more on that below) - some might say to a more buyer friendly approach (which is less usual for the European market) – there is more likely to be deferred consideration or earn-out arrangements, completion accounts rather than a locked box mechanism and perhaps more willingness to include MAC clauses in the deal documentation (which are generally speaking, less typical in UK M&A).

We have also seen significant activity in the minority stake area, where asset managers sell up to 20% minority equity (or equivalent) stakes in their management businesses, with sometimes an option for the investor to take further interest(s). There are various asset managers in the market which look to take strategic minority stakes in other asset managers, sometimes by way of a passive investment, at other times taking a more formal and involved role in the target or adopting a hybrid approach – providing consultancy services to their investee companies to support and guide the continued growth of their businesses, and in certain cases looking to exploit synergies between investee companies in terms of new products and service offerings. In particular, European asset and wealth managers have been a keen area of interest for U.S. managers which specialise in identifying opportunities for acquiring minority interests. This was a trend that has picked up in the last year or so but there seems to be even more noise in this space currently – there are of course various drivers for these types of acquisitions, on both buy and sell-side. On sell-side, these might include a realisation of value without a complete exit, facilitating succession planning and the bringing through of a new generation to the equity, access to greater infrastructure / capital and/or access to a wider client-base. On buy-side, we often see strategic stake acquirers looking at targets that will diversify their portfolio, or identifying targets that have growth potential once they have access to (often) the larger buy side business, in addition to the acquisition simply representing an opportunity to take an interest in a target's top line revenue streams.

We have been seeing an increase in consolidation across the sector over the last several years with distressed low performing assets delivering valuation multiples of between 3x and 16x depending on the asset. This increase in M&A activity trend has allowed the industry to achieve growth underpinned by a number of key drivers.

Drivers of consolidation have included:

1. **Build private market portfolios in areas such a ESG** - e.g. Schroders-Adveq (PE), Franklin-Benefit Street and BlackRock-Tennebaum (Private Debt), BlackRock-First Reserve Energy Infrastructure Funds (Infrastructure), Legg Mason-Clarion Partners, Schroders-Blue Asset Management (Real Estate), Schroders-BlueOrchard, Federated Investors-Hermes (Impact investing/sustainability).

2. **Drive AUM Scale** - in traditional asset management (Janus-Henderson, Standard Life- Aberdeen, Invesco-Oppenheimer, Franklin-Legg Mason, Natixis-La Banque Postale), in passives/ ETFs (Invesco-Source, Invesco-Guggenheim, WisdomTree-EFT Securities).

3. **Enhancing distribution capabilities including through Fintech** – geographical scope (Amundi-Pioneer, BlackRock-Banamex, Amundi-Sabadell), direct to consumer (Victory-USAA). Schroders acquisition of Lloyds Wealth Management business, BlackRock-FutureAdvisor, Alternative Solutions (BlackRock-eFront).

V-shaped recoveries - for GDP and M&A

Chart 2: Global M&A trends (by value; all sectors)

Source: The Institute for Mergers, Acquisitions and Alliances (IMAA); Simmons & Simmons

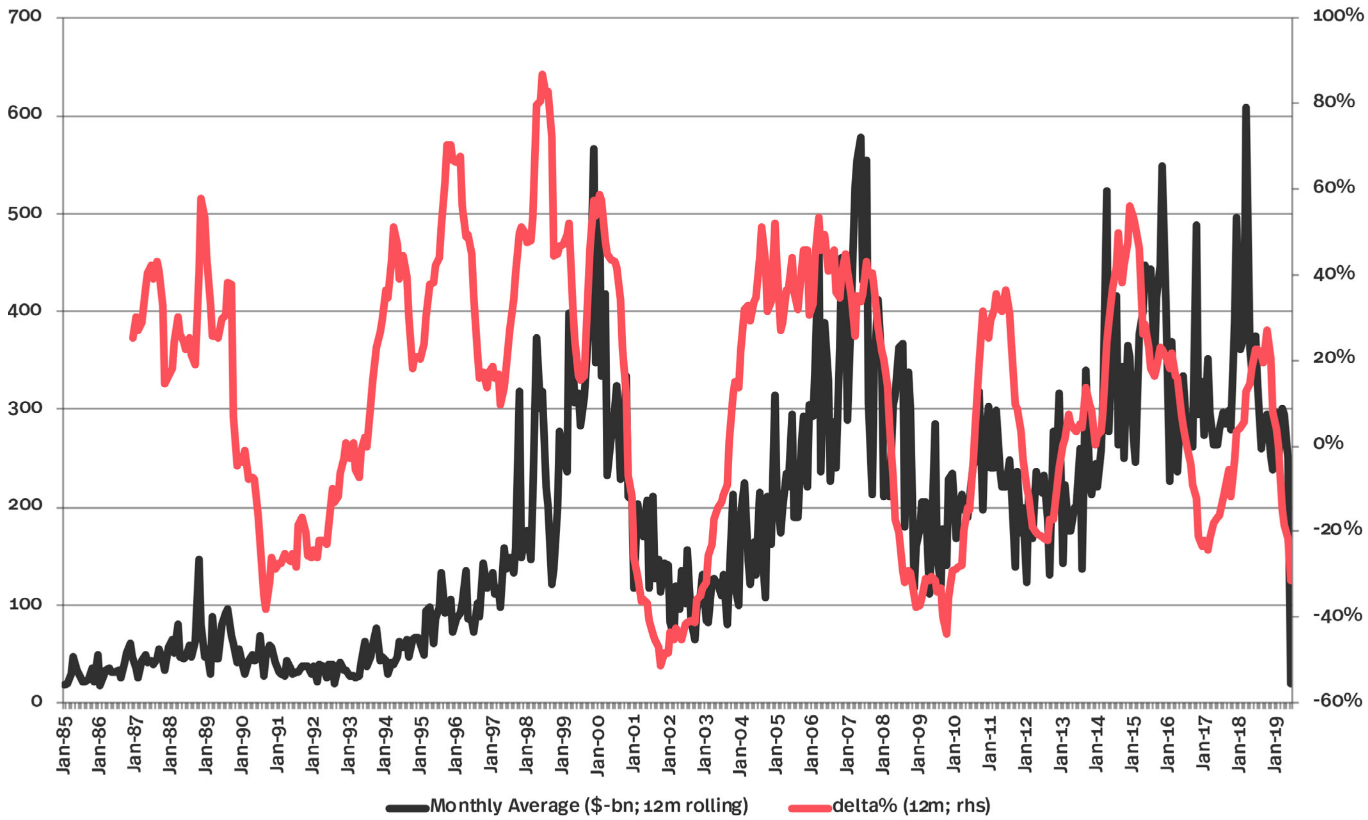


Chart 1 above traces global M&A activity since 1985 and, importantly, through 2 major downturns and now into a third - all of them since the turn of this century. The last 20 years or so of the 20th century seem positively halcyon by comparison to the first 20 years of this century.

The data above represents (black line, left hand axis) the monthly value of M&A transactions (smoothed using a rolling 12-month average) and (red line, right hand axis) the change in the average transaction value compared to the same month in the prior year.

They show that in each of the previous 2 major downturns (the 'tech-wreck' starting early 2000 and GFC starting 2007/8) the nadir for monthly transaction values was a 51% drop (y/y) during the 'tech-wreck' (in October 2001) and 44% during the GFC (in October 2009). In both cases the annual change (y/y) turned positive 23 months and 10 months after their respective nadirs.

The current downturn in monthly transaction values shows a drop of some 31% - approaching the lowest point of the GFC but not yet in 'tech-wreck' territory - but the pace of decline is fast and could close the gap around the summer of this year.

If so, and if history is any reliable guide, it might suggest a nadir around Q3/ Q4 and a gradual improvement in transaction values throughout 2021. A turning point also perhaps for the stock of 'dry powder' hence by private funds reported (by Prequin) to have reached $2.5 trillion at the end of 2019, some 50% of which is in buyout funds (33%) and 17% in Real Estate funds. Given the level of dry powder already it seems likely that capital calls will abate, if they have not done so already, before resuming later this year or into 2021.

That shape would line-up with the expected (if slightly skewed) V-shaped recovery for global GDP where latest forecasts from the IMF (June 24th, 2020) and earlier ones from the OECD (June 10th, 2020) both point to a turning point in the current recession around the same time with global GDP roughly recovering pre-COVID levels by the end of 2021.

Therein of course lies the biggest caveat of all - the pandemic itself. The world has plenty of experience dealing with recessions most of which have been largely self-inflicted wounds on the financial system caused by varying degrees of "irrational exuberance".

But the modern world has no experience of dealing with a pathogen on the scale we are enduring at the moment. The emphasis therefore is not only on spotting value and longer-term trends but also on the effectiveness of the test and trace protocols deployed around the world to allow lockdowns to be relaxed and economies to come out of hibernation. The V-shaped recovery for GDP and for M&A activity is predicated on there being no second wave of pandemic (see below for M&A highlights from our Horizon Scan of the post-COVID New Normal).

M&A Highlights from AM2025 - More Corporate Action

Last year we published another piece of Horizon Scanning looking at the future of the Asset Management industry - a major client survey in conjunction with Bloomberg LLP [Click here for survey results]. In it we asked the asset management community about how it saw the future to 2020 and to 2025.

Clearly no-one was thinking then about COVID-19. But assuming there is no second wave and that the V-shaped recovery described above remain intact, some of the signals they were sending in response to that survey are likely still to be valid, perhaps more so, under current circumstances.

For example, and perhaps the strongest continuing trend, almost 60% of respondents remarkably anticipated some form of corporate action over the following 2-7 years. At the time their response seemed to be driven by some combination of factors including succession planning, relentless margin pressure, tighter regulation (especially in UK/ Europe) and the rise of 'active -passive' strategies (e.g. smart beta, ETFs).

Those drivers, especially margin pressure, are still in play and, although regulatory pressure may in places be temporarily eased or suspended, they are now compounded with challenges around operational cash-flow and portfolio liquidity.

And while that survey and its conclusions were focused on the Asset Management industry there are a number of direct read-across points for other sectors too. Crudely stated, cash-flow pressures are intense almost everywhere. On IMF figures, while corporate debt (as % of local GDP) has fallen in places like Japan and Spain by some 40% each (from 140% and 130% respectively) it has risen sharply in France and China by roughly 60% to around 140% and 150% respectively. Even with interest rates again at record lows the pressure from reduced or collapsed revenues will be intense.

All of which resonates strongly with the finding that around 13% of our survey put their hands up to say they wanted to be acquired. If they have survived so far they may be even more keen to do a deal.

Horizon Scanning for M&A features from post-COVID New Normal

Earlier this year we published our scenario analysis-based on Horizon Scanning the post-COVID 'New Normal' - the world a couple of years from now assuming global GDP has recovered its pre-COVID levels. This link will take you to the full analysis but the following are some highlights which are likely to shape the trends and features in M&A for the 'New Normal' - planning for which may already be underway:

Pandemic resilience

The world cannot afford another COVID. Expect continuing focus on investment opportunities (and managers who can identify those opportunities) involving:

- companies able to develop new vaccines quickly - likely AI-driven
- tackling the loss of biodiversity e.g. companies able to plant new/ restore old forest
- track and trace e.g. app developers with GDPR compliant solutions
- PPE - agile manufacture to mobilise global supply quickly

Remote Working

Likely to become more sticky

- increased broadband requires increased data/ cyber security in homes, presenting new investment opportunities
- reduced demand for traditional office space: re-purpose as flexible or even as residential, requiring additional capital and new / different skill sets for investors

ESG

- increased focus on S & G, alongside the E
- data/ AI driven compliance to deal with increasing regulatory burden
- increased infrastructure spend on achieving carbon-neutral economies and resulting need for capital

Asset Management

- democratisation of assets. The suspension of dividends and share buy-backs as a condition of the special fiscal support measures and the continued low interest rate environment will reduce total returns from public markets and further drive retail demand for access to higher yield private equity type returns
- robo advisors/ QIS etc

Rising nationalism/ trade tensions

- more in-country deals
- 'vertical' M&A as companies buy-in strategic suppliers
- Brexit: increased likelihood (est 40%) of ending 2020 with no extension/ no FTA. Likely to add pressure to do deals especially among smaller asset managers with limited management bandwidth/ balance-sheet headroom to undertake contingency on-shoring to EU27

COVID coda

COVID may bring some secular change to the long-term trends seen in M&A. Data from the Institute for Mergers, Acquisitions and Alliances (IMAA) shows that since the mid-1980s the dominant country and sector themes for M&A have been the USA/ Banks and Oil. The geopolitical trends we identify for the post-COVID world may reframe those to be Asia/ China ... technology/ life sciences and, in asset management, fintech/ alternative investment and wealth management.

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