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InsideOps | Insights for Asset Management Operations Leaders

The Chief Operating Officer as "Chief Acquisitions Officer"

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To achieve growth targets and diversify their businesses, asset managers must consider acquisitions. Organic growth, through new sales and products, takes time and hard work - and luck. For firms that want to "move the needle," the quickest way is through acquisition. A critical component of any acquisition is operations due diligence. This is typically the responsibility of the Chief Operating Officer.

The Role of Operations Due Diligence in Acquisitions

A recent asset manager's acquisition of an asset manager with a complementary product offering demonstrated how effective operations due diligence can positively impact an acquisition. The acquirer's dominant position as market leader offered an ideal strategic fit with the target, who offered complementary products and investment talent. Additionally, there were overlapping operational units that allowed the new firm to consolidate middle office processes, custody bank relationships, and other administrative functions. The combined firm was able to gain operational scale by integrating middle and back office functions, and retained most clients and assets under management.

Chief Operating Officer as "Chief Acquisitions Officer"

The Chief Operating Officer (COO) plays a central role in evaluating and executing acquisitions. COOs typically run the due diligence process. They devise plans to effectively merge post trade processes, as well as manage services and vendor relationships to drive down costs. In essence, the COO must focus on two major initiatives within the acquisition process:

1. Validate the soundness, efficiency, and effectiveness of operations being acquired

2. Determine which operations, systems, and resources will survive or be merged to achieve synergies and cost efficiencies

A well run acquisition will always surface issues that affect the price paid, the structure of the merged firm, and overall ROI to the buyer. Often times deals don't move forward because of what was learned in the due diligence process.

Operations Due Diligence

Operations due diligence, or "ODD", involves reviewing the operational aspects of an investment manager. The scope of this assessment includes everything from post trade settlement through to financial statement reporting. During this process the COO should consider the impact the new operation will have on the buyer's existing operations and ultimately how these processes will be combined. The COO will inherit responsibility for the target's operational needs, and must own the ODD process to assess the target's current state operating model. The COO must gain comfort with middle office and back office operations. Important considerations include: control procedures, workflows, quality control metrics, transaction volume and error rate reporting. For example, if the target is processing trades, there should be well defined trade processes that are documented with standards and metrics around reconciliations, settlements, corporate actions, and valuation.

Trade Processing

There should be discipline around how trade instructions are captured and processed from clients, preferably in an automated environment. Sample controls may include using "auto confirm" to cross check that trade instructions were transmitted correctly. Even with a strong control environment, every firm makes mistakes occasionally, and the target firm must provide a record of operational losses the firm has experienced over the most recent five years, and explain how these were resolved.

Pricing and Valuation

The target should have a documented price hierarchy that defines what type of prices are used (bid, ask, mid, etc.), which vendors have priority, and at what point an evaluated price is used. Firms should have proper oversight procedures in place that validate the valuation done by external providers.

Oversight of Service Providers

Investment management operations include the oversight of service providers. Most, if not all, asset manager rely on a custodian to settle trades, safe-keep assets and complete accounting. A review of these custodian activities should be done to assess effectiveness and accuracy. Additionally, if fixed income or securities lending programs are in place, the COO must understand how providers are managing collateral. An effective fixed income or alternatives manager will have daily reporting to indicate exposure to counterparties in the aggregate.

Compliance

Due diligence of compliance functions will vary depending on the acquiring companies' business lines. The assessment should include reviewing the qualification of the Chief Compliance Officer and staff, compliance manuals and procedures, and regulatory history. High risk areas should be a focus and consider the following questions: are the books and records up to date, when was the last SEC, FINRA, CFTC or other regulator audit; what were the results, is the firm up to date with new regulations, do they have capable technology. Most importantly, is there a well-established "Culture of Compliance"?

Risk Management

The target firm should have a designated Chief Risk Officer (CRO) responsible for monitoring and managing risks across the firm. The major categories are investment risk, operational risk, and credit risk and the importance of each will vary with the asset classes being managed. For example, fixed income managers should have robust credit risk metrics and reporting, and transparency around counterparty risk levels. Firms engaging in primarily exchange traded securities should have robust metrics that measure operational risks. The CRO should be a member of the firm's Investment Committee. Firms should have sound disaster recovery and business continuity plans in place. It is especially important for the firm to explain how they managed events of 2008, assuming they were in existence at that time, and preferably stress tests that show how they would fare in a similar crisis. From an acquisition due diligence standpoint, an assessment on a holistic basis should be conducted to obtain a comfort level with the controls, procedures and policies that are in place to mitigate operational risks.

Technology

Technology platforms play a critical role in the day to day operations of an asset manager. Depending on the infrastructure of the target firm, the operations teams may have multiple internal platforms, leverage service provider platforms or some combination thereof. Regardless of the arrangement, due diligence should confirm the current state of the technology infrastructure. An effective ODD review will evaluate the appropriateness of the accounting system, compliance, reporting, analytics, and risk systems used, relative to asset classes and strategies employed by the target firm. Similarly, trading systems often cater to specific asset classes and strategies.

Primary areas of the ODD technology review are:

- Appropriateness of systems used, relative to strategies and asset class
- Support model: does firm have its own technology area, or do they rely on external resources?
- Release: is the firm using the most recent releases of software, and if not is this posing limitations or risks?
- Integration: are systems well integrated to pass trade and other information, or are manual or work- around solutions heavily employed?

Consideration of Operational Synergies

Realization of acquisition return on investment is partially dependent on achieving operational economies of scale. Although not technically a function of the operations due diligence process, the Chief Operating Officers of the acquiring firm along with the Chief Financial Officer will forecast the potential saving from consolidation of operations post acquisition. The COO must determine the consolidation implementation plan, including which teams will be reserved, which systems should be retained, merged or retired and what functions can be outsourced.

Publicly held acquiring firms will often only pursue acquisitions that would be accretive to earnings. The due diligence exercise will help the COO identify costs that can be eliminated in a combined firm. The COO should present a realistic and achievable picture of the possible expense synergies. Many acquisitions fail when integration teams find out that deal teams made unrealistic assumptions about synergy opportunities.

One synergy area of focus that can impact operations budgets falls within product structures. Mutual funds, hedge funds and other products allow certain operations costs of the manager to be absorbed by the funds. This varies by manager and by product. For example, some mutual funds allow fund compliance and administration fees to be paid by the fund while others do not. Depending on the target's and buyer's circumstances, synergies may or may not exist. Careful due diligence by operations, legal and compliance teams is required to vet this area.

In addition to the more obvious shared services functions (legal, finance, HR) there are specific operational components of an asset manager that need to be understood. Some of the most common can be found in the chart below.

Conclusion

Acquisitions have become strategically important as asset managers seek to grow their business in a challenging economy where growth is low. COOs play a central role in driving acquisitions and identifying show stoppers by conducting an effective operations due diligence process, and harvesting synergies that further drive profits In today's environment, operations leaders also need to be "Chief Acquisitions Officers" to expand their businesses.

Asset Manager Operational Components for Potential Synergies

Synergy Area	Opportunity	Barriers to Watch For
Accounting Platform	• Decreased licensing and support costs • Less support required for data integration • More efficient use of staff resources through functionalization	• Strategies and asset classes of target firm may have significantly different accounting requirements • Conversion costs may make consolidation uneconomical • Client service may not permit functionalization
Trading Desks	• Decreased licensing and support costs • Synergies within trading staff, if trade desks can be consolidated	• Asset class specialization in trading function may not allow centralization
Fund Administration	• Consolidation of financial reporting and administration systems • Consolidated use of vendors may provide improved negotiating position	• Regulatory and reporting requirements of different vehicles may require different teams

Source: Beacon Consulting Group

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