Facing the Challenges of Mergers and Acquisitions

Mergers and acquisitions are complex processes that involve combining two or more organizations. The process typically involves various stages, including strategic planning, due diligence, negotiations, and integration. Investment management firms can engage in different types of M&A activities, including mergers, acquisitions, joint ventures, and strategic alliances.

In July 2023, PwC released a survey that concluded that one in six asset managers will be acquired or go out of business in the next five years. The chances of a firm being involved in a merger or acquisition – from either side – are significant, and firms that are prepared are best positioned for success.

One of the primary reasons why investment management firms engage in M&A activities is to increase their assets under management (AUM). Merging with or acquiring another firm can help the acquiring firm to expand its client base, gain access to new markets, and diversify their product offerings. In addition, M&A activities can also help firms to gain new talent and resources, improve operational efficiency, reduce costs, and achieve economies of scale.

M&A activities, however, also come with significant challenges, including cost management, client retention, personnel, marketing and rebranding, combining investment operations, legal and regulatory issues, systems and technology consolidation, and bridging cultural differences. These challenges, if not planned for and managed effectively, can negatively impact the business and its clients. The issues facing firms can be grouped into three broad categories:

- **Investment Operations**
- **Organizational Changes**
- **Investment Strategies and Products**

Although Meradia's focus and expertise is in transforming investment operations, this paper will highlight a few items in the other areas as they have potential to impact operations. Considerations for mitigating some of these challenges are covered at the end of the paper.

INVESTMENT OPERATIONS

1. Integration of Systems: The integration of systems and new technology is one of the most significant operational challenges that investment managers face during M&A. This includes, but is not limited to, the integration of portfolio management, accounting, compliance, trading, performance and attribution, CRM, billing, and risk management systems. Integration of systems can take time, and if not done correctly, it can result in data discrepancies, which can negatively impact investment decisions, performance, and client servicing.

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INVESTMENT OPERATIONS (continued)

To address this challenge, investment management firms must undertake a comprehensive analysis of both their own and the target company's technology infrastructure. This analysis will help identify any compatibility issues, redundancies, and gaps that need to be addressed before the integration process can begin. Once these issues have been identified, firms must develop a detailed integration plan that outlines how the technology and processes of the two firms will be merged.

Additionally, each firm in the M&A transaction may have its own proprietary systems, tools, and platforms that have been developed and customized over time. When the two companies merge, the IT teams must evaluate these bespoke systems and tools. They must determine which legacy tools will be maintained or retired. In some cases, it may be necessary to develop new systems from scratch, which can be time-consuming and expensive. The goal is to have a unified technology stack that can support the combined business.

The first step in addressing these challenges is to identify and map out the different systems, applications, data sources, and technologies used by both companies. This can be a laborious process as there may be several overlapping systems that need to be reconciled. The IT teams need to analyze the systems to determine which ones can be integrated, which ones need to be replaced, and which ones can be retired. This analysis can also uncover the potential gaps in the systems that need to be addressed. System configurations and settings also must be reconciled and rationalized.

Trading is an essential function for investment managers. Firms rely on trading systems to execute trades and manage portfolios. The trading systems need to be integrated seamlessly to ensure that there are no disruptions to the trading operations. The IT teams need to ensure that the trading systems can communicate with each other, if multiple systems are maintained, and that the data is synchronized across the systems.

Investment management firms may also face challenges with legacy systems during M&A activities. Legacy systems are older technologies that may not be compatible with modern systems. These systems are typically difficult to maintain, and finding skilled personnel to support them can be challenging. The cost and complexity of migrating data from legacy systems to modern systems can be significant, and this process can take a long time, leading to delays in integration.

To address legacy system challenges, investment management firms may need to consider modernizing their systems before engaging in M&A activities. Modernizing systems can involve upgrading hardware and software, migrating data to modern systems, adopting new technologies, and considering moving certain functions to the cloud.

Once the systems and technologies have been identified and mapped out, the IT teams can start to develop a plan for the integration process. This plan needs to be comprehensive and cover all aspects of the technology integration, including data migration, system configuration, testing, and training. The plan needs to be communicated clearly to all stakeholders to ensure that everyone understands the process and the potential impact on the business.

2. Data Migration, Management, and Integration: Merging investment firms may have large amounts of data that need to be migrated to a single system or data warehouse. This can be a complex and arduous process, and if not done properly, it can result in data corruption or loss. It is important to have a well-designed data migration plan in place to ensure that all data is transferred securely and accurately. Data may be stored in different formats, databases, or file systems, making it difficult to integrate and analyze the information. It is essential to ensure that the data is accurate, complete, and can be accessed by the relevant parties.

The IT teams need to ensure that the data is migrated accurately and that any errors or discrepancies are identified and resolved before the systems go live. The integration of data is crucial to ensure that the merged entity has a complete and accurate view of its operations. Inaccurate or incomplete data can lead to errors in reporting and investment decision-making. In addition, the data itself may be structured differently, making it difficult to merge and analyze. Normalizing the data is an important process that must be completed in order to compare and merge the data.

Not all acquisitions involve the entire firm. In many cases, a team or subset of a firm is acquired or “lifted out”. In these situations, firms must be especially aware of conditions or limitations surrounding data access. In some cases, firms will not have any access to the data from the target firm. Special attention should be given to data access and, where possible, included in the terms of the acquisition. Firms should also examine the various data sources used by each firm in order to reduce redundancies. Benchmark and market data subscriptions should be reviewed to ensure that the firm is not paying twice for the same information. In some cases, firms operating with a decentralized decision-making model may unintentionally have multiple subscriptions to data sources.

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In large-scale M&A transactions, it is very easy for these expensive items to get lost in the shuffle or linger when stakeholders, who are dependent on the data, fear making any sort of change. While many firms believe there are savings to unlock by consolidating subscriptions, this may not be the case in practice. Expanded coverage or accessing data from different regions can drive prices higher, rather than lower due to expected economies of scale.

Investment management firms must develop a comprehensive data management plan. This plan should identify the data that needs to be migrated, the data that needs to be archived, and any data that can be discarded. In addition, the plan should outline how data will be mapped and normalized from the two firms' existing systems to the new, integrated system.

3. Investment Performance: Investment performance is what clients "eat" what firms sell and is often a significant factor in how portfolio managers are compensated. To say that it is essential to get it right is an understatement. M&A activity can cause numerous challenges for performance. Even if all the data is available, when migrating to a new system, it is nearly impossible to recalculate performance and arrive at precisely the same numbers. Different systems treat various transactions slightly differently, creating challenges in making the number match. Attempting to do so is a sure way to spend a lot of time and nurture incredible amounts of frustration.

Firms will also need to examine the rules (regulatory and, if compliant, the GIPS standards) to determine if the track record of an acquired firm can be linked to the ongoing performance of the new or merged firm. Because performance is often the driver of M&A activity, firms should review the rules with exceptional attention and consult outside counsel and expertise as necessary. A worst-case scenario would be to acquire a firm and later find that you do not meet the rules surrounding portability.

Bringing the performance from an acquired or spun-off entity is a major consideration, not just from a regulatory or GIPS perspective, but also from a data perspective. How much history should be brought to the new firm, and what level of detail? Are account level market values sufficient, or is position-level or tax lot data needed? Firms should consider the depth of data needed for today's analytics, as well as anticipating the needs for future endeavors.

Like other areas of the firm, the performance group must reconcile two sets of policies and procedures. Everything from calculation methodologies and pricing models to GIPS composites and reporting needs to be reviewed, consolidated, and aligned. Firms must ensure all marketing materials are updated with appropriate disclosures and relevant consultant databases reflect the necessary changes. There are no shortcuts here, and the sooner these activities commence, the better.

4. Cybersecurity: The merger of two firms increases the risk of cyberattacks as the number of potential targets increases. As such, it is essential to conduct a thorough cybersecurity risk assessment and implement necessary measures to protect the firm's systems and data. The merged entity must have a robust cybersecurity program in place to protect against cyber threats. This program should include regular risk assessments, employee training, and the implementation of technical safeguards such as firewalls and encryption.

ORGANIZATIONAL CHALLENGES

1. Organizational Structure Integration: One of the first things firms must determine is how the new organization will be structured. In the case of an acquisition, it may be as simple as adding the acquired firm's people and functions to their counterparts in the acquiring firm. In the case of a merger, or when an acquired firm represents new business lines or products, careful thought must be given to how the pieces will fit together. If efficiencies are to be realized, duplicate functions should be consolidated and integrated as quickly as possible.

2. Staff Retention and Training: Talent retention is a challenge in any M&A, but it is particularly crucial in investment management. Retaining talent requires careful planning and communication with employees. Investment management firms rely on highly skilled and experienced professionals to develop investment strategies, conduct research, and manage client portfolios. In particular, investment managers often face the challenge of retaining key personnel, such as portfolio managers, especially when the acquiring firm has a different culture or compensation structure. Losing key personnel can result in the loss of critical knowledge and expertise, which can negatively impact investment performance, client servicing, and revenue. Investment managers must identify their key personnel and develop a plan to retain them during and after the M&A process. The merged entity must have a clear plan for the integration of the two firms' personnel, including job responsibilities, compensation, and benefits. Firms should consider providing incentives such as retention bonuses and career development opportunities.

Firms should be prepared for staff departures, as some will not want to remain for the transition or, anticipating being let go, will leave for other opportunities. Investment managers must also ensure that they have a robust talent management system that can identify, develop, and retain talent in the long term.

Managing the staff, particularly when there are redundancies, is another challenge. The merged entity may need to restructure the workforce, which can be a difficult and delicate process. It is important to have a clear plan in place for managing the workforce and communicating any changes to the employees. To the extent possible, career planning resources should be provided, and advance notice given to allow staff to transition.

Staff training is also important when completing an M&A transaction. The merging firms will likely have different operating policies, procedures, or technology platforms. As a result, staff training will likely be required to ensure that all employees are familiar with the new systems and processes to ensure that they can operate them efficiently. The training needs to be comprehensive and cover all aspects of the new systems, including the changes in workflows and processes.

3. Cultural Integration: Investment managers have unique cultures, shaped by their values, behaviors, priorities, and decision-making processes. It governs how work is done and how employees interact with internal and external parties. When two firms merge or acquire each other, they must reconcile their corporate cultures to ensure a smooth transition and avoid potential conflicts. In recent conversations, culture was identified as the top concern firms face and the one requiring extensive due diligence at all levels and not limited to speaking to senior level staff.

Cultural integration requires investment managers to understand the cultural differences between the two firms, identify areas of alignment and divergence, and develop a plan to bridge the gaps. Investment managers must communicate their values and vision clearly, create a shared sense of purpose, and foster a culture of trust, respect, and collaboration. They must also ensure that the new culture reflects the values and needs of their clients and stakeholders. To be successful, these values cannot simply be handed down from the top, but rather their development and agreement should involve staff from all levels of the organization.

Investment management firms should develop a comprehensive cultural integration plan. This plan should include strategies for communicating with employees, identifying cultural differences, and creating a unified culture. Thought must be given to how these values will be promoted and internalized. Involving staff from various levels and areas throughout the organization to develop and lead that plan is critical to its success.

4. Consolidation of Operations: Moving from the organizational structure to the nuts and bolts of how the business operates is vital. Defining what the target operating model will look like and mapping out a plan for how to move from the current state to the future state is essential. This includes streamlining processes, eliminating redundancies, optimizing workflows, and documenting policies and procedures. The inflection point presented by an M&A transaction offers the opportunity to modernize, enhance risk management, and optimize efficiency.

5. Client Retention: Client retention is another operational challenge investment managers face during M&A transactions. Clients are the lifeblood of investment managers, and any disruption or uncertainty during the M&A process can cause clients to withdraw their assets, leading to significant revenue losses. Projected client retention is one of the drivers of many M&A transactions, so it is essential to ensure the retention of the maximum number of clients.

Investment managers must communicate clearly with their clients about the M&A transaction, the benefits of the deal, and any potential risks or challenges. Clients may be concerned about the impact of the merger on investment performance, service levels, and fees. Investment managers must address client concerns promptly, provide assurances about the continuity of their services, the safety of their assets and information, and, in some cases, even offer incentives to retain clients. Investment managers must also ensure that the new firm has the capacity, expertise, and resources to meet the evolving needs of their clients.

6. Compliance and Regulatory: Investment management firms operate in a heavily regulated industry and are subject to strict requirements. A merger or acquisition can result in changes to these requirements, which can create challenges for the firm's compliance program. Failure to comply with regulations can result in fines, reputational damage, and legal liability. Investment management firms need to ensure compliance systems are integrated to ensure that the new firm complies with all the relevant regulations.

Each firm likely has different compliance policies and procedures, which may require changes and alignment. Managing the compliance function during the transition of the M&A can be particularly challenging. The management and trading of client accounts continues throughout the transition and needs to be monitored, along with all other activities. Planning must consider how compliance items will be monitored and reported on, thresholds for various measures, and when compliance oversight will cross over from the old firm to the new firm.

Protecting firm and client data is also an important element to consider. Investment firms must maintain strict controls over the access, storage, and transmission of sensitive financial information. During a merger or acquisition, security, and compliance become even more critical. The two firms may have different data security policies and procedures, and integrating these policies can be challenging.

Investment managers must identify any gaps and redundancies and develop a comprehensive plan to address these issues. It is important to work closely with legal and compliance teams to ensure that all regulatory and disclosure obligations are met. It is essential to have a plan in place to ensure that the firm remains compliant with all regulatory requirements during and after the merger or acquisition. In addition, firms must ensure that all employees are trained on the new policies and procedures and that they understand their role in maintaining a secure and compliant environment. This is particularly important when there are changes to policies resulting in different limits or prohibitions.

INVESTMENT STRATEGIES, PRODUCTS, AND IMPLEMENTATION

1. Consolidating Investment Strategies: Another challenge faced by investment managers during M&A is the integration of investment strategies. The investment managers of the acquiring firm may have a different investment philosophy and strategy from the investment managers of the target company. Therefore, it is important to align the investment strategies of both firms to ensure a smooth transition.

Firms must decide which strategies will continue, which will be terminated, and which will be merged with existing strategies. Different managers may have different styles, philosophies, techniques, and tactics on implementing their strategy, which can create friction points. This can make it challenging to align the investment team and implement a cohesive investment process that is consistent and efficient.

Firms need to evaluate their investment committees as well. Who will participate? Will some staff be voting members while others are not? How will investment decisions be made in the new structure? While there will certainly be adjustments along the way, firms (and their clients!) are well served to have as many of these details decided before the go-live date of the merged entity.

2. Trading: Merging the trading function and activity of two firms presents opportunities as well as challenges. Increased lot sizes may yield better executions for smaller firms. At the same time, if the merged firm is very large, it may find it more difficult to minimize market impact. Another benefit from a merger or acquisition is the sharing of knowledge and strategies. While not limited to the trading function, the increased knowledge base can be quite valuable.

Firms should consider how the trading function will be implemented within the merged entity. Will trading be centralized through a trading desk, or will it be decentralized and put in the hands of portfolio managers? Do the firms execute different trading strategies, and, if so, how will those be reconciled? Which order management systems will be used? What type of pre and post-trade analytics will be utilized? Which platforms or brokers will the firm use? Discussing these issues and developing an implementation plan early in the process will help set the firm on course for success.

3. Research: The research function is another area that deserves attention in an M&A transaction. Similar to the other functions, firms are wise to consider how the research activity will be structured. Will it be a centralized function, or will the responsibility for conducting research be delegated to the various portfolio management teams? Will investment ideas be presented to the investment committee for approval? How will research targets be assigned?

Different firms have different styles, strengths, and weaknesses to their research capabilities. Firms should review how their investment universe coverage will look and how it will be distributed under the merged firm. In order to save cost and maximize efficiency, it is important to review the tools, external data sources, and subscriptions used by research to eliminate any redundancy.

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MITIGATING OPERATIONAL CHALLENGES

- **Do the Due (Diligence)**
- **Plan, Plan, and Plan Some More**
- **Communicate Clearly and Continually**
- **Over Budget Time and Resources**

1. Due Diligence: Many of the challenges previously noted can be identified through the due diligence process. This helps to shape a roadmap of planning that must occur and issues to be resolved. Can a firm perform too much due diligence? Probably not. It is critical to bring in relevant subject matter experts to review and opine on various parts of the firm being acquired. It is worth restating that company culture is one of the most important factors to examine and can make or break the success of a transaction.

2. Pre-transaction Planning: Investment managers can mitigate operational challenges by conducting comprehensive pre-transaction planning. This includes identifying potential operational challenges, developing integration plans, and identifying key personnel and client retention strategies. Firms should develop detailed actionable plans for each of the operational challenges noted above. It is essential that the plans should be clear regarding timing, sequencing, dependencies, contingencies, resources required, and responsible parties.

3. Communication: Effective communication is critical during an M&A transaction. Investment managers must communicate clearly and regularly with employees, clients, and other stakeholders, providing updates on the progress of the transaction and addressing concerns and questions promptly. In particular, clients may be concerned about the impact of the transaction on their investments. Therefore, investment managers have to provide regular updates to their clients and address any concerns they may have. Employee communication is also essential in order to efficiently and effectively execute implementation plans and ensure the merged firm is able to operate successfully on day one. Firms should establish regular communication channels and collaborate with key stakeholders to ensure that the integration process is as smooth and seamless as possible. As with most things in life, setting proper expectations is critical. A firm recently shared that when they were acquired, they were told that the acquiring firm did not intend to make any changes. What the firm meant was that they did not intend to make any changes to the investment strategy, while investment operations, marketing, etc., would undergo significant changes. This type of miscommunication leads to distrust and hard feelings, making a transition even more challenging.

4. Integration of Technology Systems: Investment managers can mitigate the challenges of integrating technology systems by conducting a comprehensive review of the systems used across all operations of both firms and developing a detailed integration plan. The plan should include sufficient depth and breadth of testing to identify and address data discrepancies, discover incompatibilities, minimize disruption, ensure the continuity of service, and budget sufficient time to make any adjustments as a result of the testing.

5. Develop a Data Strategy: Developing a data strategy can help firms address data management challenges during an M&A. This strategy should include data mapping, data cleansing, and data migration plans. Meradia developed a proprietary approach to assessing data called the Performance Readiness Data Assessment. As the name implies, the PRDA evaluates the data necessary for investment performance and analytics. The assessment reviews the data for gaps, incompatibilities, non-normalization, and structure. Incorporating such an assessment as part of the firm's data plan can save time and money down the road by identifying problems early on, remediating them, and establishing a durable architecture for the future.

6. Retention of Key Personnel: Investment managers can mitigate the challenge of keeping key personnel by developing retention strategies. Such strategies do not necessarily have to focus exclusively on compensation. It is important to establish a culture and ethos such that employees want to remain at the firm. Inducements such as bonuses, equity incentives, and career development plans are important, but so are things like flexible work arrangements, charitable work (and gift matching), comfortable work environments, and non-compensation benefits.

7. Client Retention: Firms can lessen the risk of client departures by providing regular and effective communication, providing assurances about the continuity of service and investment performance, and developing transition plans that minimize disruption. A clear articulation of the firm's value proposition, enhanced investment thesis, and expanded services or products will not only encourage existing clients to remain at the firm but may also encourage additional investment from them, as well as attract new clients.

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8. Over-Budget for Transition: Firms often find themselves pinched by insufficient funding, time, or people power to develop the necessary plans to support an M&A transaction. In addition, freeing up headcount to focus on executing those plans can be challenging while also delivering on business-as-usual responsibilities. Bringing in consulting horsepower to focus on the transition frees up the staff to continue to perform their normal duties. This leads to greater client retention and reduces employee burn-out. Over-budgeting both time and resources will provide a buffer for ensuring a successful transaction.

Mergers and acquisitions present significant operational challenges for investment managers, including integration of technology systems, consolidation of operations, staff retention, client retention, and compliance and regulatory challenges. These challenges can be mitigated through effective pre-transaction planning, transparent communication, integration of technology systems, retention of key personnel, and client retention strategies. Generously budgeting for the transition in both time and resources sets the firm up for success. By effectively managing these challenges, investment managers can improve their operational efficiency, expand their client base, and enter new markets, thereby enhancing their competitiveness and growth prospects.

HOW MERADIA CAN HELP

Meradia is uniquely positioned to assist firms with both technological and operational transformations. M&A transactions offer an opportunity for firms to rethink, reengineer, and redesign their investment operations. From data assessment, migration, and architecture to organizational structure, operating model, and policies and procedures, Meradia has the experience and expertise to help firms through transition and drive success.

Jonathan Boersma, CFA oversees projects for Meradia's investment performance practice, including operational outsourcing, compliance, and consulting services for firms adopting the Global Investment Performance Standards (GIPS®). He leverages 28 years of financial services experience to guide clients through the complex strategic assessments and operational transformations. Jonathan blends strategic planning with industry best practices to ensure Meradia's clients achieve investment performance operations efficiencies. Jonathan helps clients with assessing their current operating model, identifying opportunities for efficiencies, risk mitigation, and process improvements to design a future-state operating model. He assists firms develop a road-map and guides them through implementation of that plan.

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