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From diligence to delivery

Capturing value from retirement record-keeping M&A

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Given the US defined-contribution market's abundance of competitors, pricing pressure, and the IT-intensive nature of the business, it is no surprise it has gradually consolidated over the past decade. Much of this consolidation has been organic; stronger competitors have leveraged competitive pricing, distribution excellence, and superior experience for intermediaries, sponsors, and participants to take share. However, M&A has also played an important role in consolidation: J.P. Morgan, Mercer, New York Life, and The Hartford all sold record-keeping businesses to strategic buyers.[1]

We expect this consolidation to continue. While valuation gaps between buyers and sellers exist in the market, top firms will still likely continue to gain share, and firms should be prepared for further record-keeping M&A.

M&A can generate meaningful value in record keeping by creating access to new market segments, expanding distribution capacity (including for proprietary products), and positioning the combined entity to capture the benefits of scale. A transaction can also serve as a catalyst for change by creating an opportunity to transform operating models, overhaul legacy technology, or address operational complexity.

Too often, however, strategic acquisitions in the record-keeping space have not delivered their full potential and the economics fall short of pre-deal models. As a result, potential buyers should have a clear understanding of what is required to be successful and leverage a highly tailored approach to the M&A process, recognizing the uniqueness of the industry. Off-the-shelf or generic playbooks that are not tailored to the industry actually risk destroying more value than they create because they do not capture the unique complexities of the record-keeping space.

This article highlights the key points of leverage in a record-keeping transaction that a buyer should address to maximize a transaction's value. Importantly, this is not a comprehensive guide to executing and integrating a record-keeping acquisition. Instead, it presumes the buyer has the basics in place: a clear strategic rationale for the deal (such as new segment entry, increased distribution capacity, or scaling), an empowered and skilled deal team, and established pre- and post-deal processes to create and capture value.

[1] At the time of writing, Wells Fargo announced an agreement to sell its record-keeping business to Principal Financial.

The value of focusing on revenue synergies

Given the potentially attractive returns to scale in record keeping, there is a strong bias to over-index on driving cost synergies as part of an acquisition. Even when the rationale for a deal includes a compelling revenue-optimization story (for example, introducing proprietary target-date funds or stable value products), executive focus tends to drift toward cost because cost synergies are easier to measure. To be clear, work on cost synergies is important and should be undertaken quickly (particularly given the challenges inherent in platform consolidation). That said, we believe that by focusing on revenue synergies at the start, buyers can form the right culture from the outset and minimize value leakage.

Forming the right culture

News of an acquisition will create anxieties, particularly for the target's staff, who will wonder if they will be the first cost synergies to be realized. This underlying anxiety can lead to tension, and integration meetings can quickly feel like two boxers circling each other rather than a single team focused on maximizing value. Quickly overcoming this tension is important. The longer it persists, the more value will be lost.

Focusing on growth helps move the integration team beyond early anxieties and refocus it on shared success. A high-growth environment has more opportunity for all to benefit. Simple steps (e.g., ensuring that early agendas focus on leveraging capabilities to deliver best-of-breed products and services from across the legacy businesses) build a more effective integration team while visibly demonstrating the importance of growth to the rest of the organization. This builds credibility of management intentions and conviction within the employee base, thereby creating a stronger culture in the combined company. Even a handful of quick wins to drive growth can quickly replace "us" and "them" with "we" and accelerate cultural integration.

Protecting the book

Dis-synergies are a fact of life, and in record-keeping mergers, there is a risk that the target will face heightened plan departures with the announcement of a transaction. This dynamic could even set in prior to a formal announcement if the target announces it is conducting a strategic review and is placed on various intermediary watch lists. Retaining sponsors (and their intermediaries) should be a priority from day one.

Consider the following scenario: a record keeper that has historically focused on offering proprietary products and developing lifetime multiproduct relationships with participants in midmarket plans acquires an independent large- and jumbo-plan record keeper that has focused on providing stand-alone record-keeping services without offering proprietary products or engaging participants out of plan.

Investment-product penetration and proprietary sales are critical parts of the deal rationale. However, realizing full value will be no small accomplishment. The target's business mix means its intermediaries are more typically institutional consultants, who quickly call the sponsor to discuss the acquisition's implications, including the advisability of moving the relationship to another provider that more closely adheres to the services-only model. As a result, the economic value of the target could quickly be at risk.

Clearly, time is of the essence. The acquirer needs a proactive strategy for the systematic engagement of at-risk sponsors and intermediaries. This engagement strategy should be on the critical path and at the top of the integration agenda, with full C-suite support from both leadership teams. Senior executives will need to convey personally the transactions' benefits for these plans and their participants.

Consider an alternative scenario in which a small-market record keeper seeks scale by acquiring a similarly positioned competitor. Given the target's small-market focus, there is a reduced risk that a handful of plan departures materially impair deal value. That said, the seller's book likely contains certain "power" advisors or intermediary institutions—ones that have placed significant volumes of business with the seller. This transaction could be a catalyst for these advisors or institutions to move their books. Chances are, the buyer will have strong relationships with a couple of these institutions and their home-office gatekeepers but weaker or non-existent relationships with others, thereby leaving it exposed.

In this situation, the team needs to move quickly, simultaneously reaching out to power advisors through the target's pre-existing wholesaler relationships and sending joint delegations from the buyer's and seller's leadership teams to engage home-office gatekeepers at at-risk institutions to ensure the new company can step into the target's position on various approved and preferred provider lists. Failure to execute on either level can lead to meaningful but avoidable outflows.

Winning with the right talent

Among the assets a buyer acquires, robust distribution and sponsor-relationship-management teams are likely to be among the most valuable (particularly in new market entries). These assets, however, can and will walk out the door if the buyer does not quickly take proactive steps to retain key talent after the transaction announcement.

Retention, however, is only half the battle. The buyer needs to move quickly to train the new talent on the new entity's value proposition so they can appropriately position their employer in the market. In situations in which the combined entity offers a meaningfully different value proposition vis-à-vis both legacy companies, the acquirer's team will need to be retrained as well. Training should not be limited to the field. Sponsor relationship managers, who must be prepared to engage sponsors that will have questions regarding the transaction, need to be rapidly trained as well. Too often, the focus will be on generating near-term cost synergies by rationalizing the relationship-management function. In the days that immediately follow a transaction announcement, the focus should not be on preparing post-closing head-count reductions. Instead, it needs to be squarely on arming these functions with the knowledge and insights they will need to be effective.

Summary: Revenue actions to accelerate value creation and minimize leakage

— Put revenue synergies at the top of the integration team's agenda to find common ground, build trust, and score early victories.

— Have a clear articulation of how the target's sponsors and participants benefit from the acquisition and ensure that it consistently forms the basis of external communications.

— Quickly get in front of power advisors, consultants, and home-office gatekeepers to stem the risk of being put on a watch list or suffering unnecessary outflows.

— Prioritize the training of distribution and sponsor relationship managers on the new entity's value proposition and benefits to maximize revenue gains and mitigate unwanted plan attrition.

— Move quickly to ensure that the best aspects of each party's product and service offerings are brought to market in an integrated fashion by the combined entity.

— Recognize that not all of the target's wholesalers will be happy with the deal. In fact, some will use it as an opportunity to do a market check for their services. Be prepared to offer retention packages to the most productive members of the team.

— When acquiring a different business model (for example, an insurer acquiring a wealth-management owned business), recognize that it will take a sustained effort to retrain the target's (and potentially the acquirer's) wholesalers and account managers on the new entity's value proposition.

Securing cost synergies

For all the promise of extracting meaningful cost savings through mergers, the record-keeping industry's history of capturing the opportunity is spotty. Part of the challenge is that mergers can involve businesses with different business models or market segments in which market conduct varies enough to require specialized, market-specific capabilities that are not easily rationalized. More fundamentally, fully realizing cost synergies often requires consolidation of core record-keeping platforms, which is a difficult and time-intensive exercise under any circumstance. At best, it involves consolidating different instances of common third-party platforms. The presence of one or more homegrown proprietary systems can increase complexity materially. Finally, there are certain tactical issues that frequently bedevil buyers. For example, a seller's customer relationship management, contract, and, potentially, transactional data will often lack structure or reliability because sellers frequently cut back on investing in anticipation of an exit. This is particularly true in the small end of the market, an area in which underlying contracts—which can go back decades—are often inconsistently catalogued due to their sheer volume.

This is not to say cost synergies are illusory. Quite the contrary: they can and must be achieved as part of a deal. Depending on how closely aligned the business models of the target and acquirer are, and the level of simplification and automation in place, the cost-reduction opportunities can be material across the board. Typically, the greatest opportunities (in terms of percentage cost reduction) are associated with G&A and product areas (up to 50 percent) followed by O&T, where savings are largely deal specific (from 10 to 15 percent to over 50 percent) and highly dependent on the level of simplification of existing service models and underlying platforms. In the remaining functions (e.g., investment management, marketing, distribution), cost-reduction opportunities are typically less than 20 percent.

Several important lessons can be gleaned from the industry's recent experience.

Understanding that segments matter

Having a clear understanding of what can be accomplished with mergers across segments is critical not only in valuation, but in integration as well.

Too often, acquirers overestimate what can be accomplished and by when, particularly when they are entering a new market segment through a transaction. A small-market provider might overestimate how much it can reduce account-management and servicing costs with a target that caters to jumbo providers, because the jumbo segment will require customized service levels whereas the small-market provider's operations are geared toward standardized servicing. Similarly, record-keeping platforms differ across segments, and it is highly likely a small-market provider will be on a platform with very different capabilities from a large-market provider.

Understanding these dynamics early in the deal process can prevent downstream disappointment.

Tackling procured expense early

An acquisition creates new opportunities to rethink third-party spend and drive savings through vendor rationalization and increased bargaining power resulting from greater scale. As an added benefit, savings on third-party spending do not have the same cultural or emotional impact as head-count reductions.

Procurement teams at most financial institutions, however, lack the sophistication or maturity we see in other industries. As such, acquirers should make sure they have the right talent in place to maximize the procurement opportunity—and be prepared to make upgrades if necessary. A 10 percent or more savings in combined procured expense can provide a rapid down payment on the deal.

Consolidating platforms to drive downstream value creation

In our experience, realizing the full potential of cost synergies generally requires consolidation of core record-keeping systems, which is a heavy lift. While platform consolidation has some parallels with large-scale, bulk plan migrations, there is a critical difference in the sheer volume of data that must be transferred. When a homegrown platform is involved, the complexity can increase materially: proprietary systems often have significant data-architecture challenges and come with large technical debt (because the sellers would have stopped investing in the systems as it became clearer they were selling).

Given these challenges, integration teams frequently settle for work-arounds in the near term (for example, building an overlay in the contact center to allow service representatives to use a single workbench) while deferring an increasingly theoretical commitment to true consolidation of platforms—or abandoning the aspiration altogether. The downstream consequences are real in regard to customer experience, operational efficiency, and risk. For example, providers either maintain multiple front-end portals or build a single portal but have to wire changes through to the back end multiple times, increasing IT cost. In participant contact centers, service representatives need to be cross-trained on multiple systems or calls need to be routed to specialized teams, which reduces flexibility and raises staffing levels. In the field, it creates complexity for wholesalers, thereby reducing sales effectiveness. Importantly, it exponentially increases execution risk because processes need to be prepared for every possible variation; errors can be overlooked for years and have costly consequences, both financially and reputationally.

When embarking on consolidation, it is critical to have a strategic but disciplined execution strategy and clear expectations. First, platform selection is an important strategic decision, one warranting C-suite-level engagement. Second, a single senior executive (ideally reporting to the business head, with the ability to mobilize key stakeholders) should lead the consolidation effort and be held accountable for its performance. Too often, consolidation efforts are treated as IT projects that

Summary: Cost actions to capture synergies

— Record keeping is a market of markets. Conduct can be very different from one market to another. Be clear-eyed about what can be accomplished through cost synergies (particularly in the case of new market entries) and reflect this view both in deal negotiation and integration execution.

— Take a hard look at procured expense early. An acquisition likely affords the opportunity to rationalize vendors and negotiate superior pricing.

— When pursuing platform consolidation, keep the following actions in mind:

- Savings are material and are not limited to IT-application expense (this perspective will come in handy when facing the surprises that are inevitable in a consolidation effort).
- Be strategic about the target end state. The bar for consolidating onto a proprietary, home-grown system should be high.
- Make platform consolidation a CEO or business-unit president agenda item and fully dedicate a senior executive to lead the initiative.
- Start planning for consolidation immediately—ideally, concurrently with revenue actions. It is the long pole in the tent for synergy capture. Given that full consolidation can take years, delays can have compounding effects that can stretch well into the future.

— Use the acquisition as a galvanizing event to disrupt legacy mind-sets, service models, and operating models.

operate one or two levels too low in the organization. Burying the effort in this manner guarantees unsatisfactory results.

Streamlining service models

Alongside complex technology, the industry struggles with another remnant of its past: countless bespoke, plan-level service arrangements. When record keeping was a high-margin distribution channel for proprietary products, such customization was economically feasible. In most cases, however, the technology could not support this degree of customization. As a result, client service teams created work-arounds (often manual) to deliver the agreed-upon service to sponsors and participants, a practice that led to a commensurate increase in operational cost and complexity. Strikingly, many plan sponsors and participants do not value these complex service arrangements, and often are not even aware of them. As plan agreements age and personnel change, many current decision makers are not aware of what their predecessors requested and why.

A transaction creates a unique opportunity to start fresh. When redesigning the value proposition and product offering, record keepers can pair these with popular and streamlined service configurations, creating plan and participant journeys that are easier to use and less expensive to support. Customization will still be important in the large market; however, some of the supporting work can be automated or streamlined so that it does not require manual intervention. These changes can be packaged as end-to-end upgrades and conveyed to plan sponsors and intermediaries as benefits of the deal. This allows the integrated entity to leapfrog both of their current states, migrating to streamlined, technology-enabled service models that better meet client needs with a fundamentally lower cost structure.

The record-keeping industry is at a pivotal point, with an opportunity to innovate how it creates meaningful value for plan sponsors and participants while revolutionizing its cost structure to become sustainable in the long term. M&A is an important tool for providers to accelerate this change. Successfully delivering on an acquisition strategy requires skillful execution that is grounded in both best practices of merger integration and the unique complexities of record keeping.

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