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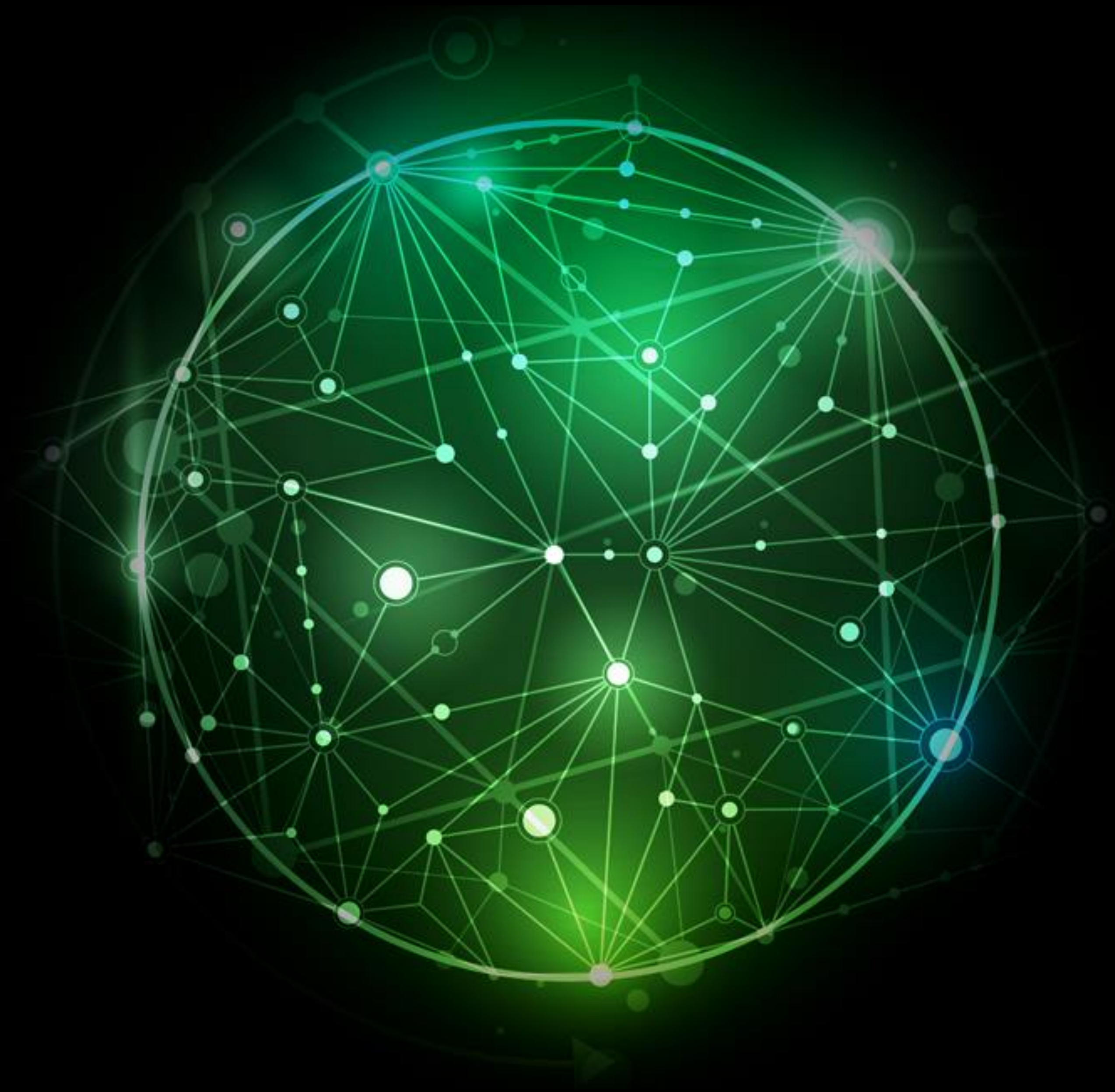

2024 Australian Investment and Wealth Management Sector M&A Outlook

Seeking opportunities and prospects in a new world

October 2023

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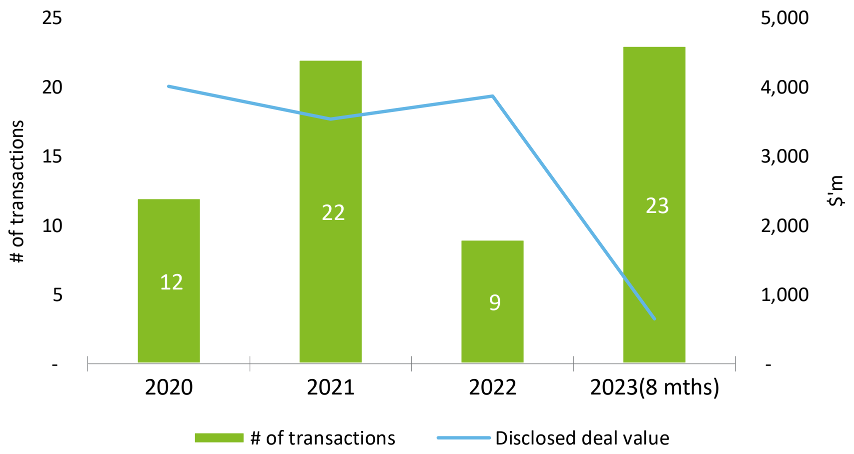
Introduction

As the Australian investment and wealth management industry continues to face heightened inflation, volatile market conditions and regulatory changes, market players will have to find ways to achieve growth and economies of scale as well as exploring untapped opportunities such as sustainable investing and digital transformation.

Growth in economic activity is forecast to remain subdued for the rest of 2023 and into 2024 [1]. Inflation in Australia is gradually easing from its peak at the end of 2022 but still remains high, with the RBA forecasting a decline to around 3.25% by the end of 2024. Interest rates are expected to reach their peak by the end of 2023, while growth in household wealth is anticipated to pick up[1]. While this poses a challenge to market players in terms of margin compression due to rising costs and strong competition, there are still reasons for cautious optimism. Furthermore, volatility provides opportunities as firms look to differentiate and transform. Global private equity (PE) dry powder soared to a record $3.9 trillion ($US2.49 trillion) around the middle of 2023[2]. The record levels of dry powder (available capital) support tailwinds for M&A in the investment and wealth management sector as PE firms look to deploy some of that capital to acquire suitable targets – on both the general partner/manager level and as portfolio companies for their private equity businesses to diversify asset classes in the alternatives sector. This trend is exemplified by US alternative asset management giant Blackstone becoming the first alternative asset manager to manage $1.5 trillion ($US1 trillion, with its dry powder increasing over the last 12 months from $253 billion ($US170 billion) to $290 billion ($US195 billion)).

The resilience of local market players has been put to the test in recent years by global spill-overs including geopolitical issues, supply chain disruption and foreign banking developments. Significant local developments such as the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry and Quality of Advice Review have also impacted the financial services industry, particularly wealth management with more than 12,000 financial advisers exiting the sector since 2019[3]. This has resulted in a structural trough for adviser numbers in the market and necessitated transformation in existing business models.

I&WM transactions in Australia[4]



As investors' appetite for digitally driven engagement/insights shows no signs of slowing, firms are adopting digital transformation to deliver information advantage by harnessing data and artificial intelligence (AI). Financial services are one of the industries facing a 'short fuse, big bang' scenario which means generative AI will have a large impact to the industry in a short time frame[5]. This is also signalled by ASIC placing AI as a 'high and important priority'[6].

Sustainable investing has come into the vernacular of both consumers and corporates in recent years, as stakeholders look to incorporate ESG practices and principles into their strategies. According to the ASX's 2023 Australian Investor Study, almost a third of surveyed investors said they use responsible investing principles in their approach and this proportion is poised to grow with more awareness and education as almost one in four investors are unaware of responsible investing[7]. This has seen a small amount of M&A in the ESG-led investment management sector, however limited targets of scale have hampered strong deal volumes on this thematic.

Financial technology (Fintech) will also remain a popular target area for M&A activity. On the back of the changing funding landscape which saw slower venture capital funding in the first half of 2023 compared to the same period in 2022[8], Fintechs will potentially turn to inorganic options to survive or exit such as M&A. The stage is set for investment management firms/platforms seeking to build economies of scale and defend their market share, as they look to acquire their non-traditional competitors' technological capabilities and facilitate transformation.

With an increasingly competitive industry as retail investors take on a more active role and become more price sensitive, this shift in investor behaviour will prompt wealth management market players to be more adaptable to the changing nature of the market and investor demands. Competitive advantage may come in the form of taking a more proactive stance in digital adoption and fine tuning of investment strategies/allocations by exploring diverse ways to invest whether it may be in responsible investment products or exchange traded funds (ETFs).

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The search for growth and scale in the Investment and Wealth Management sector and the potential impact of the Quality of Advice Review, will drive M&A activities into 2024.

Below we explore the key focus areas driving Investment and Wealth Management sector M&A in the Australian market as we look ahead into 2024 and beyond.

Focus area 1: The Impact of the Quality of Advice Review

The Quality of Advice Review – Final Report was released by the Treasury in early 2023. The report contains recommendations that are largely consistent with the draft proposal released August 2022, with some new items and minor amendments. The report raises questions about the customer experience and necessary shifts in business models. For relevant providers, such as financial advisers, the expected impacts include:

- simplification of administration by removing the obligation to provide Statements of Advice (SOAs) and Records of Advice (ROAs)
- replacing safe harbour steps with revised Best Interest and “Good Advice" duties
- additional administration for client consent obligations and wholesale client classification
- a clarified/simplified regime for scaled advice
- increased support from digital tools
- simplified payment from customer superannuation accounts

Financial Advice Licensees must consider how their operating and compliance models will evolve, ensuring accurate record-keeping despite the removal of SOAs/ROAs. Non-relevant providers (e.g. providers who do not receive a fee that is paid for the advice or do not satisfy the professional standards) will also be affected by the shift to a personal advice model, requiring changes in sales processes, record-keeping, monitoring, and training. Superannuation funds may benefit from expanded advice options, greater clarity on advice fees and the potential for increased use of digital advice tools, as this ensures a level, competitive playing field and encourages additional distribution opportunities.

Potential shifts in business models and heightened regulatory compliance could drive consolidation and strategic partnerships especially with the number of advisers dropping significantly since the Royal Commission. This is further contributed by businesses’ aiming to align their operations/capabilities, acquire adviser networks, achieve cost synergies to service clients and seize opportunities of the vacuums left by banks who have largely exited the industry.

Focus area 2: Trends in platform consolidation

The investment management industry continues through a period of platform M&A as platforms and service providers seek to achieve economies of scale, enhance operational efficiencies, broaden distribution channels, and expand market presence. This may come in the form of platforms acquiring smaller service providers (e.g. HUB24's acquisition of Class in 2022 and myprosperity in 2023), deals to build scale (e.g. Insignia's acquisition of MLC Wealth from NAB in 2021) or simplifying the business so firms can focus on their core offerings and key strengths (e.g. Praemium's divestment of its UK operations to Morningstar). We anticipate this will continue into 2024 with platforms looking for scale, the ongoing market shifts towards specialist/disruptor wealth platforms (e.g. Netwealth, Praemium, HUB24) while institutional/incumbents platforms (e.g. BT, Colonial First State, Macquarie) compete to hold on to market share and as legacy institutions use platform and associated wealth technology acquisitions to enable digital transformation. Consolidation would help platforms enhance their capabilities, expand their offerings and be better positioned to weather headwinds such as uncertain market conditions. These capabilities include leveraging technological capabilities, improved market access, and enhanced portfolio management tools. Increasing regulatory and compliance requirements have also placed additional burdens on platforms in this landscape.

Focus area 3: Continuous investment manager consolidation

Investment management firms are consolidating as they seek scale to achieve economies of scale in back and middle office teams, to diversify the asset classes/products offered to investors (particularly in the alternatives space) and as a result of margin/fee pressure from the continuing rise of ETFs. This is a thematic we are witnessing globally, particularly as certain equity markets fell during 2022 and 2023 resulting in global investors (pension and superannuation funds) needing to reassess asset allocation into niche areas such as private equity or real estate, alternative asset managers have acquired or merged with other managers to add asset classes to their stable in a bid to retain investor money with the manager in the hope the investor can move their money into an alternative asset class/strategy and not result in outflows.

Market players have also recognised the low cost, high flexibility, and convenience of ETFs which saw higher demand among retail investors in recent years. The 2023 ASX Investor Study found 20% of investors held ETFs in 2022, up from 15% in 2020[9]. The Australian ETF industry also hit a record high by surpassing $156 billion in total assets under management (AUM) in August 2023[10]. We expect ETFs to continue to be an attractive investment as investors seek to diversify their portfolios and take advantage of this relatively affordable way to start investing amidst a volatile market. With increased scale, companies are competing on price to attract inflows with organisations like Blackrock and Betashares reducing fees on their ETFs in 2023. In addition to price, to satisfy investor demand and fill in the gaps of a sector that's historically dominated by 'vanilla ETFs', firms may also explore introducing or investing in more niche/thematic offerings (e.g. energy transition and cloud computing ETFs) as well as active ETFs. ESG themes were notably present among the new local offerings in 2022, with 14 of 41 new ETFs launched focused on one or more ESG themes[11].

While the consolidation trend presents potential benefits, challenges exist as well. Cultural integration and staff retention can be complex, as conflicts may arise during the integration process. Furthermore, the success of mergers relies on preserving investment autonomy, realising synergies and executing successful integration.

Focus area 4: The impact of Digital disruption and Artificial Intelligence

The investment and wealth management sector is undergoing a significant shift fuelled by the rapid growth of digital disruption and AI. Data science, AI, and other technologies are reshaping our understanding of asset risk and improving investment processes. These include the use of big data and alternative data to provide insights and generate excess returns ("alpha"), in areas such as client profiling, asset allocation, stock selection, portfolio construction, and portfolio weight calculations. In fact, the number of alternative data sets applicable to financial services increased by c.36% over the last two years and the number of alternative data providers increased by c.29% over the same period[12]. Furthermore, operational efficiency is being enhanced by leveraging AI and automation, resulting in improved order flow management and reduced implementation costs. Product and content distribution are also being improved through the utilisation of AI-driven insights, such as the adoption of robo-advising. Lastly, AI is being leveraged for risk management and compliance functions. With examples of Deutsche Bank Wealth Management implementing their AI-powered Finantix KYC Solution to verify users, Netwealth utilising modern digital planning tools to enhance the client experience and Neilson & Co utilising ChatGPT in financial advice, technology has become an enabler in the industry. These identified shifts provide a roadmap for firms to navigate the evolving landscape and seize opportunities for transformation and value creation, where an increase in M&A activities is also anticipated by firms acquiring these digital and modern capabilities.

Focus area 5: Transformation to sustainable investing

Investment management firms are presented with compelling opportunities to adapt to evolving investor preferences in sustainable investing. ASIC recognises ESG's continued momentum and the need to be ready for the impacts[13], while the 2023-24 Federal Budget intends to allocate $14.2 million over four years to support its sustainable finance agenda[14]. ESG incorporation may no longer be a differentiator for investors and firms, but rather a standard input for consideration. ETFs that focus on socially responsible investments have 43% higher fees than widely popular standard ETFs[15], which partially explains the increasing demand for ESG products and influences investment managers to consider sustainability investment metrics in their decision-making. As of March 2023, the responsible investment market reached $154.2 billion funds under management (FUM), growing by 113% over the past 5 years, while most responsible funds outperformed the average return across the wider market based on 3-year, 5-year and 10-year compound annual growth rate (CAGR)[16]. Australian Ethical's AUM also saw a 48% growth in FY23 compared to FY22.

96% of global dealmakers are expecting ESG scrutiny in deals to increase over the next 3 years[17], proving that ESG and responsible investment may be factors to weigh in the balance when approaching potential transactions and long-term value creation. At the same time, it is essential for firms to properly consider/navigate the complexities and requirements when offering or promoting sustainability-related products to minimise the risk of regulatory breaches and avoid greenwashing.

Projections indicate that at the current growth rate, ESG-mandated assets are on track to represent half of all professionally managed assets globally by 2024[18]. It is crucial for investment managers to recognise the significance of adapting to sustainable investing, as it not only drives growth but also safeguards their competitiveness in the evolving market. Investment managers who incorporate ESG factors into their investment decision-making processes and strategies are better positioned to identify and capitalise on M&A opportunities that align with dealmakers' values and preferences. A recent example is Commonwealth Bank of Australia's equity investment in Wollemi Capital, a climate specialist investment firm.

Notwithstanding the above, there has only been a small volume of M&A of ESG-focused investment managers due to limited targets of scale or with a proven track record available for acquisition.

Conclusion

While recent macroeconomic challenges such as the rapid interest rate tightening cycle, inflationary pressures and global economic downturns have had a multifaceted impact on the sector, the outlook for the domestic investment and wealth management industry is poised for continued opportunities and transformation. Furthermore, the increasing focus on regulatory compliance, artificial intelligence, sustainable investing and changing client preferences are reshaping this industry's landscape and is expected to define its trajectory in the coming years. Factors such as firms' initiatives to embrace and utilize technology, keen understanding of trends (such as ETFs and ESG) and foresight in identifying M&A opportunities remain keys to success in an increasingly globalized and data-driven sector.

However, it is important to note that the M&A landscape is not without challenges. Integration of different corporate cultures, retaining talent, achieving expected synergies and managing regulatory compliance can be complex and require careful planning and execution. As the industry continues to evolve, a commitment to innovation, agility and client-centricity will be key drivers of success. Firms that can strategically position themselves, adapt to industry shifts and effectively execute M&A transactions are likely to thrive in this evolving landscape.

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Endnotes

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