Investment Consultants Market Investigation

Working paper: Financial performance and profitability

26 April 2018

This is one of a series of consultative working papers which will be published during the course of the investigation. This paper should be read alongside the issues statement published on 21 September 2017 and other working papers published.

These papers do not form the inquiry group's provisional decision report. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional decision report, which is currently scheduled for publication in July 2018, taking into consideration (among other matters) the evidence obtained, responses to the consultation on the issues statement and responses to the working papers as well as other submissions made to us.

Parties wishing to comment on this paper should send their comments to investmentconsultants@cma.gsi.gov.uk by 10 May 2018.

The Competition and Markets Authority has excluded from this published version of the working paper information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂]. [Some numbers have been replaced by a range. These are shown in square brackets.]

Contents

Summary

1. In this working paper we examine the financial performance and profitability of six providers of investment consultancy (IC) and fiduciary management (FM) services.

2. The six providers are the three largest providers of IC and FM services combined, by reference to total IC and FM revenues in 2016, and three smaller providers of IC and FM services combined who were able to provide us with net profit margin data for both services. The three largest providers of IC and FM services combined are not the three largest providers of FM services.

3. In this investigation, we examine profit margins in order to inform our understanding of competition: an examination of relative profits may provide useful information in examining the firms' incentives, for example in seeking to sell FM services to their existing advisory clients.[1]

4. In this working paper we discuss the issues in assessing profitability of IC and FM services, especially given that in this sector detriment could arise from low quality advice provided by IC or FM providers resulting in poor investment decisions by pension schemes, and/or in excess profits earned by IC or FM providers. On the basis of this paper, having considered the parties' responses to our initial financial questionnaire and the available data, our view is that it is not proportionate to undertake an assessment of economic profitability. Hence, we are not in a position to conclude whether providers representing a substantial part of the IC and FM sectors have earned profits that are persistently in excess of their cost of capital.

5. We have found the following:[2]

   (a) Overall, the aggregate net profit margin for IC and FM combined for the six providers in 2016 was [20% - 30%]

   (b) For IC, the aggregate net profit margin for the six providers was [20% - 30%] and [20% - 30%] for FM.

   (c) These margins are lower than the margins the FCA found for asset managers, but higher than the average operating margins in the FTSE All Share sample created by the FCA.

[1] See working paper on the supply of fiduciary management services by investment consultancy firms.
[2] All margin figures are for 2016.

6. It has not been possible to conclude whether profits are in excess of the cost of capital.

7. We invite comments on the following areas, as well as comments more broadly on the issues discussed in this working paper:

   (a) Identification of any suitable industries against which to benchmark IC and FM profit margins;

   (b) Views on whether these profit margins appear to be high and whether there are particular factors which explain this;

   (c) Identification of any further suitable profitability metrics, such as revenue per client, and

   (d) Given that we have not conducted a return on capital employed (ROCE) analysis, views on whether we should estimate any potential detriment.

Contents of this paper

8. This paper has the following sections:

   (a) Role of profitability analysis, including a discussion of the purpose of profitability analysis and its interpretation;

   (b) Our usual approach in market investigations;

   (c) Scope of our assessment;

   (d) The firms' approaches to assessing profitability of their IC and FM businesses;

   (e) The issues associated with assessing profitability in this investigation, including discussion of cost allocation and capital base, and

   (f) Review of measures of profitability. This section includes presentation of the results of the financial analysis we carried out on the six providers of IC and FM services and profit margins of asset managers.

Introduction

9. When reaching a view concerning the functioning of a market, we consider the outcomes of the competitive process in that market: including prices and profitability, product quality and range, and levels of innovation.[3]

10. While profitability analysis provides a framework for assessing the level of prices, broader financial analysis can provide insight into the various factors affecting the performance of firms and hence the competitive dynamics of the sector.

11. We do not regard 'excess' profitability in itself to be a problematic feature of any market, but instead a market outcome that provides an indication that competition problems may exist. In other words, excess profitability is one of the possible symptoms of, rather than a cause of, ineffective competition. Profitability findings may also be used in the context of determining the scale of the consumer harm or detriment that might arise, for example in the form of higher prices.

12. In this investigation, we are looking at the relevant revenues, costs and capital base of IC and FM providers. In practice, there are few large stand-alone IC and FM providers. IC and FM services are generally provided by integrated global firms who undertake IC and FM services as well as providing other types of work.

Role of profitability analysis

Purpose of profitability analysis

13. The aim of profitability analysis, as set out in the CMA's market investigation guidelines (the Guidelines), is to understand competitive conditions within a market by examining the outcomes of that market in terms of the financial performance of the participating firms. The Guidelines state that:

> Firms in a competitive market would generally earn no more than a 'normal' rate of profit – the minimum level of profits required to keep the factors of production in their current use in the long run, ie the rate of return on capital employed for a

[3] Guidelines for Market Investigations: Their role, procedures, assessment and remedies, April 2013, adopted by the CMA, (CC3 Revised), paragraph 103.

particular business activity would be equal to the opportunity cost of capital for that activity.[4]

14. The purpose of profitability analysis, therefore, is to understand whether the levels of profitability (and therefore prices) achieved by firms are consistent with levels we might expect in a competitive market.

Interpretation of profitability analysis

15. In interpreting the results of our analysis, we take into account a number of factors. First, the Guidelines recognise that at particular points in time the profitability of some firms may exceed what might be termed the 'normal' level. There could be several reasons for this, including cyclical factors, transitory price or other marketing initiatives, and some firms earning higher profits as a result of past innovation, or superior efficiency.[5]

16. However, a situation where profitability of firms representing a substantial part of the market has exceeded the cost of capital over a sustained period could be an indication of limitations in the competitive process.[6]

17. On the other hand, the Guidelines highlight that a finding of low profitability does not necessarily signify that competition is working well, since low profitability may be concealing ineffective competition. For example, incumbent firms, despite being protected from new entry, may not earn high profits because they are inefficient and operate with higher costs than would be sustainable with stronger competition in the market.[7]

18. The trend in profits over the period of review will be an important consideration as an indicator of improvements or deteriorations in the competitive environment. For example, where profitability has increased over a number of years, this may indicate a worsening of the competitive situation or weakening of competitive pressures in the reference markets.[8]

19. Finally, to put our profitability assessment into the wider context of our market investigation, in reaching a view about the functioning of the reference markets and determining whether any market feature, or combination of features, has or have an adverse effect on competition (AEC), profitability will be only one of the outcomes of the competitive process we will be taking into account, and we will take into account evidence on other market outcomes,

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[4] CC3 Revised, paragraph 116.
[5] ibid, paragraph 117.
[6] ibid, paragraph 118.
[7] ibid, paragraph 125.
[8] ibid, paragraph 124.

including product quality and range; and levels of innovation. We will consider prices and profitability in the context of our overall assessment, and while useful, findings that price-cost margins are wide or profitability is high in a market do not on their own provide conclusive evidence that the market could be more competitive; such findings are not in themselves causes of competitive harm – they are not features of the market for the purpose of the AEC test.[9]

Our usual approach

20. In measuring profitability, our approach is often to start with accounting profit produced in line with UK Generally Accepted Accounting Practice (GAAP)[10] and then to make adjustments to arrive at an economically meaningful measure of profitability, usually in terms of rates of return on capital, where the capital base is valued accordingly.[11]

21. The CMA often informs its judgement on what is an 'economically meaningful measure of profitability' by examining the management accounting records of the firms in question. We consider the manner in which firms assess profitability for the purposes of monitoring and reporting performance, as this may inform our view as to what is an appropriate measure for the industry in question.[12]

22. An important factor to consider when selecting an appropriate model will be data availability. Where possible, the CMA will base its calculations on financial data that can be reconciled to audited financial statements, albeit with appropriate adjustments.[13]

23. There is also the need to obtain an appropriate value for capital employed. The Guidelines state that in industries with a relatively low level of tangible assets, such as service and knowledge-based industries, the book value of capital employed may bear little relationship to the economic value because of the presence of significant intangibles.[14] Obtaining a value for capital employed can present difficulties irrespective of the choice of profitability model; a return on capital approach, whether return on equity or return on

[9] CC3 Revised, paragraph 126.
[10] Now likely to be International Financial Reporting Standards (IFRS) for most of the parties.
[11] CC3 Revised, Annex A, paragraph 9.
[12] Ibid, Annex A, paragraph 9.
[13] Ibid, Annex A, paragraph 11.
[14] Ibid, Annex A, paragraph 12.

capital employed, requires an economically meaningful value for the capital base which may not accord with the value ascribed in the financial records.[15]

24. We may consider adjustments to accounting data produced in line with UK GAAP relating to the difference between historical cost and replacement cost, and relating to the inclusion of certain intangible assets where certain criteria are met.[16] We discuss this further later in this paper (see paragraphs 64 to 68).

25. The Guidelines state that, in situations where capital employed cannot be reliably valued the CMA may consider alternative measures, such as the return on sales (ROS) or other relevant financial ratios. For instance, comparisons with businesses operating in different but similar markets may on occasions be helpful.[17]

Scope of our assessment

26. Our terms of reference define the reference markets as the supply and acquisition of investment consultancy services and fiduciary management services to and by institutional investors and employers in the UK.

27. Consistent with the terms of reference, we examine the profitability of the provision of IC and FM services separately. We have not presented financial information on IC- or FM-only providers, consistent with our theory of harm concerning incentives of IC providers to steer their clients to their own in-house FM services.

28. We examined the profitability of the three largest combined providers of IC and FM services in the UK, namely Aon, Mercer and WTW (the three largest providers). Collectively, they make up close to but below 50% of IC and FM revenues.[18] We note that these three providers are not the three largest providers of FM: Aon is the [✂] largest provider of FM services. River & Mercantile and Russell Investments are [✂] and [✂] largest, and although these two larger providers also provide IC services, they are not in the top ten.

29. We also present financial information on three smaller providers of IC and FM services who were able to provide us with net profit margin figures for IC and

[15] CC3 Revised, Annex A, paragraph 13.
[16] ibid Annex A, paragraph 14.
[17] ibid Annex A, paragraph 15.
[18] 2016 revenues. Between 45% and 49% of the IC market and between [✂] and [✂] of the FM market

FM, namely, [✄]. Collectively, they make up 8% of IC revenue and 17% of FM revenue.[19]

30. The Guidelines state that the appropriate time period over which to examine the persistence of the gap between profitability and the cost of capital may vary according to the specific market, and that the pattern of investment and nature of sources of competitive advantage may affect the CMA's view of the relevant timescales over which it would expect to see competition playing out in the market.[20]

31. We seek to balance this aim with the constraints faced by the IC and FM providers to provide us with reliable and consistent financial information requested, which may be problematic given past acquisitions and divestments, as well as changes in financial reporting systems and cost allocation approaches, for example.

32. We originally asked the parties to provide financial information for the five years 2012 - 2016. However, although the parties provided revenue information for the five years, it was only possible to examine net profit margins[21] for 2016 for all the parties.[22]

The firms' approaches to assessing profitability of their IC and FM businesses

33. As noted in the Guidelines we consider the manner in which firms assess profitability for the purposes of monitoring and reporting performance may inform our view as to what is an appropriate measure for the industry in question.[23]

34. Ideally, we wished to find a measure of the profitability of IC and FM providers taking into account all relevant costs and an appropriate capital base. In assessing the viability of doing this it is important to consider how the firms are organised and how the firms monitor and report performance, both externally and internally.

35. All of the three largest providers of IC and FM services are global professional firms, providing a range of services in addition to IC and FM services. Their IC

[19] 2016 revenues.
[20] CC3 Revised, paragraph 121.
[21] Gross profit is revenues less direct costs; net profit is revenues less all costs (direct and indirect costs); net profit margin is net profit divided by revenues, usually expressed as a percentage. Net profit margin is equivalent to return on sales.
[22] [✄] told us that, prior to 2016, indirect shared costs were not allocated to FM in its management accounts, and thus its margins for IC and FM were not comparable from year to year or between each other.
[23] CC3 Revised, annex A paragraph 9.

and FM businesses are not structured as a standalone entity for any of the three providers, instead included in a wider 'retirement', 'investment' or 'wealth' entity which also includes other service lines.[24] Thus there is no publicly available financial information on just the IC and FM businesses.

36. The management accounts of the three largest providers of IC and FM services were split by service line, thus financial information for each of IC and FM was available. All three of the largest providers were able to provide, for IC and FM, revenues, direct costs, and indirect costs, and thus gross and net profit.

37. We asked the parties how they measured profitability of IC and FM, to enable us to understand whether assessing the profitability of IC and FM was possible. The parties use measures largely based on revenues, as well as gross (or direct) profit, and net profit.

38. [✄] told us that it measured various revenue metrics such as new business revenues, staff utilisation rates, recovery rates, and work in progress (WIP) and WIP provisions; various 'controllable' cost metrics such as headcount and salary/bonus costs; allocated and attributed costs; and net operating income margin.

39. [✄] told us that it measured revenues, direct margins, pre-tax income and headcount, as well as salaries, direct margin, and pre-tax income all as a percentage of revenues.

40. [✄] told us that it measured revenues, staff costs, total operating costs and operating income, as well as revenue per full time employee (FTE), but that its focus for the investment business was on the global P&L and not so much on individual parts of the business.

41. We were interested in understanding how the three largest providers treated costs incurred by their IC and FM businesses, to enable us to assess whether the providers calculated a profit that closely related to actual costs. Direct costs are costs directly incurred by the IC and FM businesses and indirect costs are costs incurred outside the IC and FM businesses, and then allocated to the IC and FM businesses. An example of a direct cost is staff costs; examples of indirect costs include manager research and central functions such as finance, HR and CEO office. Costs which could be direct or

[24] Aon's IC and FM business is included in its 'Retirement Solutions' business line; Mercer's IC and FM business is included in its 'Wealth' division; the overwhelming majority of WTW's IC and FM business is included in its 'Investment, Risk and Reinsurance' business segment (the remainder is captured with its Retirement business which is part of its Human Capital and Benefits line).

indirect depending on the company / business structure include rent and other office and operational costs.

42. In respect of the 2016 financial information, all the three largest providers, with the exception of [✂], told us that they had allocated all relevant indirect costs to arrive at net profit and net profit margin.[25]

43. [✂] told us that it allocated indirect costs based on usage (eg by headcount, revenues, or square footage, depending on the category of cost). This included what it termed the 'global asset engine' (for example, manager research costs and global investment systems and platforms).

44. [✂] told us that the majority of indirect or fixed costs (including property, IT and infrastructure, and functional (finance, HR, CEO office) costs) were shared through allocations, and that a significant proportion of FM activities was undertaken in [✂] and costs were allocated for the purposes of the analysis for the CMA.

45. [✂] told us that indirect costs of occupancy costs, depreciation and group central allocations were apportioned by headcount or salary and that professional insurance costs were apportioned by risk-adjusted revenues; it did not apportion research or operational costs[26] in the normal course of business but for the purposes of the IFQ response, it had apportioned these on the basis of revenue.

Issues in assessing profitability of IC and FM services

46. In this section we consider whether it is possible to obtain appropriate data from the three largest providers of IC and FM services to assess the profitability of IC and FM. We consider that there are a number of issues to consider in assessing profitability, including cost allocation and capital base.

Cost allocation

47. As noted at paragraph 35 above, the three largest providers of IC and FM services provide a range of services in addition to their IC and FM services. IC and FM services may sit within a wider investment or retirement business unit, which may sit within a wider UK business. The UK business is in turn part of a

[25] [✂] told us that before 2016, it did not attempt to allocate indirect costs between IC and FM with all such costs being allocated to IC alone. From 2016 onwards, [✂] has used a high level best endeavour basis to allocate 'management accounting indirect costs' based on their underlying drivers. There are further indirect costs, that are not allocated in the management accounts; these are however reflected in the statutory accounts and further reduce the observed profitability of both IC and FM.
[26] These functions support both the IC and FM service lines.

global network. The parties told us there are many shared and common costs. As noted above, some costs are incurred directly by the IC and FM businesses, such as staff, travel, system licence, specific marketing, and in some instances professional insurance and occupancy costs. Other costs may be incurred elsewhere and charged to the IC and FM business, such as research and property costs, which we would term as indirect costs. There are also shared or common costs, such as network costs, group central costs, operational costs (HR, IT, finance etc) and depreciation, which are incurred centrally and allocated to the IC and FM business, which we would also term as indirect costs.

48. [✄] told us that a substantial part of the cost base was common across IC and FM, and that it would be difficult to establish a meaningful way to allocate common costs across different sub-practices; any measure of profit before interest and taxes (PBIT) would be based on [✄] specific approach to cost allocation and thus influenced by [✄] business structure.

49. [✄] told us that it had an [✄] which carried out day to day operational and back office servicing of FM clients, and [✄] for producing FM performance reporting. It told us that a substantial share of the FM cost base was allocated / attributed given the multinational operating model used to deliver services to clients. It also told us that a substantial portion of the costs for the IC and FM business were allocated, given where these sit within the larger [✄] business. This is borne out by the relatively large amounts of indirect costs shown in [✄] financial information it provided to us.

50. [✄] did not tell us about any problems it had with allocating costs to its IC and FM businesses.

51. We acknowledge the fact that the parties incur a large proportion of indirect costs, and that there are challenges in accurately allocating these costs on a meaningful basis. Nonetheless, we understand that, with the exception of [✄], which does not apportion research costs in its P&L, and [✄] (see paragraph 42), the parties have allocated indirect costs to their management accounts in the ordinary course of business. The parties also use profitability measures which reflect this allocation of indirect costs in order to monitor and assess performance.

52. We therefore think that the issue of cost allocation is not a major hurdle to overcome in a profitability analysis.

Capital base

53. The three largest providers of IC and FM services are companies as opposed to partnerships.[27] The assets on a global professional services firm's balance sheet such as the three largest providers of IC and FM services include tangible assets, such as property, plant, equipment, working capital, and intangible assets (to the extent that they are recognizable under accounting standards) such as goodwill and software licences. Any costs incurred by the firm relating to brand development, human capital, and intellectual capital such as processes and know-how, are not allowed to be recognised as assets on the balance sheet under accounting standards. However, firms derive value from these and such non-recognised intangible assets are likely to have a significant value for a professional services firm.

54. There are two issues relating to the measurement of the capital base. The first relates to the availability of a balance sheet as a starting point for measurement of the assets employed by the IC and FM businesses. The second relates to identification and measurement of intangible assets.

Balance sheet as a starting point

55. As noted above, the IC and FM businesses are not structured as a standalone statutory entity for any of the three providers, and instead are included in a wider 'retirement', 'investment' or 'wealth' entity which also includes other service lines, and therefore the capital base for the IC and FM businesses is shared with other service lines.

56. Submissions from the parties mainly focussed on the difficulty of identifying and measuring intangible assets, but the parties also mentioned the difficulties in measuring tangible assets relating to the IC and FM businesses. [✂] told us that it did not measure capital employed for its IC and FM businesses, and only measured capital employed for the entire business; any measure of capital employed would need to reflect all relevant tangible assets. [✂] told us that it would be extremely difficult to arrive at a sensible measure of capital employed for its IC and FM services. [✂] told us that there were significant challenges in reliably allocating costs and capital to the [✂] UK IC and FM businesses, and that the allocation of relevant tangible and intangible capital employed would be complex.

[27] Some of the smaller providers of IC services are partnerships (for example [✂]) and there are additional issues relating to capital for these which we do not discuss here.

57. We asked the parties to provide a capital employed figure for their IC and FM businesses. None of the three largest providers, with the exception of [✂] for its FM business,[28] were able to do so.

58. [✂] told us that it was not possible to provide a reliable estimate of the capital employed for IC and FM services; it was not something which [✂] constructed, analysed or reported in the normal course of business. [✂] told us that it had not constructed this balance sheet before, meaning that the approach and efforts to construct it would be new and untested. [✂] told us that it had significant concerns about measuring and allocating capital employed to the IC and FM businesses; for instance, it had limitations in the level of detail captured by its time-recording systems and its FM staff were not required to complete detailed timesheets. [✂] told us that there were certain tangible assets that could be linked to each business line based on current accounting records: working capital, cash balances, prepayments and trade debtors; these would need to be allocated on the basis of assumption rules, eg relative revenues and headcount. [✂] also told us that there were significant challenges in allocating capital employed between IC and FM.

59. [✂] provided the 2016 balance sheet for its FM business[29] but told us that a balance sheet for its IC business had never been produced, as it was contained in [✂] balance sheet, which also contained other [✂] advisory and consultancy sub-practices.

60. We asked the parties what resources would be required to construct a balance sheet for the IC and FM businesses. All of the three largest providers of IC and FM services told us that it would be very difficult.

61. [✂] told us that the approach and efforts to preparing this balance sheet would cover new, untested ground and would take substantial time. [✂] also stated that it would take substantial time to determine and align with the CMA the relevant assumptions to undertake the modelling in a way that would be robust and comparable for the CMA's work. [✂] expected this work would take several months of input from its finance team to reach a level of depth and sophistication that could be considered reliable for the CMA's purposes.

62. [✂] told us that to disaggregate the balance sheet of its IC sub-practice from [✂] balance sheet to any degree of accuracy would be a time-consuming manual exercise, and even then, subject to a materially high level of

[28] As discussed at paragraph 53, this balance sheet would not include any non-recognised intangible assets.
[29] [✂]

approximation that would not justify the considerable time required to identify this information.

63. [✄] told us that there were significant difficulties associated with separating out the elements of the balance sheet for different parts of the business; beyond the resources required to do so, there were more fundamental issues in that there was no practicable basis for splitting these items. [✄] told us that it would in theory need to estimate the balance sheet of a hypothetical standalone business providing the same IC services as provided by [✄], and that it had not considered whether this would even be possible; at the very least, doing so would require [✄] to make a significant number of assumptions with no practical precedent to draw on.

Identification and measurement of intangible assets

64. [✄] told us that IC was an industry with significant intangible assets arising from knowledge, IP, relationships, IT, branding, etc. [✄] view was that it would be extremely difficult to estimate these intangible assets for IC as a whole, let alone how they might be allocated to IC and FM services.

65. [✄] told us that tangible assets on the balance sheet were small relative to the internally generated intangible assets and that measuring capital accurately would be challenging: there would be problems in identifying costs relating to generation of intangible assets, due to the design of the time recording systems (for example, the time recording systems are designed to keep track of billable client work rather than to distinguish time spent to non-billable work; the FM does not record time) and the fact that it would be difficult to distinguish between costs necessarily incurred in running the business and those that are additional.

66. [✄] told us that any relevant measure of capital employed would need to reflect all relevant intangible assets. The vast majority of its asset base was likely to be made up of intangible assets: for example, it invested heavily in its human capital (the knowledge and skills of its staff built up through training and on the job development); its intellectual property (its research capabilities, its systems for collecting and interpreting data for clients), its trusted reputation and its brand. It told us that all these assets required significant upfront investment but would generate benefits for it over a much longer period. [✄] also told us that while these intangible assets were inherently difficult to quantify, it was clear that its company relied on these assets to a large extent: as providers of advice, its knowledge and ability to interpret information was central to its value as a business.

67. As noted above, most intangible costs are not allowed to be included on the balance sheet. We acknowledge that in industries with a low level of tangible assets, such as service and knowledge-based industries, the book value of capital employed may bear little relationship to the economic value because of the presence of significant intangibles. The Guidelines state that we may consider making adjustments to accounting data to reflect certain intangible assets. In previous inquiries, we have considered the inclusion of certain intangible assets where the following criteria are met:

(a) It must comprise a cost that has been incurred primarily to obtain earnings in the future;

(b) This cost must be additional to costs necessarily incurred at the time in running the business, and

(c) It must be identifiable as creating such an asset separate from any arising from the general running of the business.[30]

68. In the case of IC and FM businesses, much of the asset base is intangible in the form of clients, reputation, brand, and human and intellectual capital, including staff experience and skills, and internally developed methodologies and know-how.

CMA emerging findings

69. We considered that the issue of cost allocation was not a major hurdle to overcome in a profitability analysis.

70. However, we considered that the issues of constructing a balance sheet as a starting point for measurement of the assets employed by the IC and FM businesses, and the identification and measurement of intangible assets, were more problematic, and we accept the parties' submissions that it would be very difficult to construct a balance sheet.

71. We considered that it would be very resource intensive for the providers to create balance sheets for the IC and FM businesses. We also considered that any estimates would be subject to a high level of estimation due to the number of assumptions which would need to be made.

72. As discussed in paragraph 4, given that detriment could arise from low quality advice provided by IC or FM providers resulting in poor investment decisions by pension schemes, and/or in excess profits earned by IC or FM providers,

[30] CC3 Revised, Annex A, paragraph 13

we considered that the effort required to construct a balance sheet as a starting point would not be proportionate.

73. We considered whether it would be possible to identify costs relating to creation of any intangible assets which would fall under the criteria set out in paragraph 67 above. However, given the practical and conceptual difficulties involved, our emerging view is that it would be disproportionate to attempt to assess the intangible asset base.

74. This means we have not measured the total capital employed relating to the IC and FM businesses.

Review of measures of profitability

ROCE

75. ROCE is a standard measure of profitability that compares profits with the investment in the company and that figure can be compared to the company's WACC. We would need to obtain an appropriate value for profits and capital employed to calculate ROCE.

76. None of the three largest providers of IC and FM use ROCE as a way of calculating profitability of their IC or FM services.

77. We considered that the most difficult issue in considering this analysis was the assessment of a capital base, because, as noted above, our view is that it would be disproportionate to attempt to calculate the tangible and intangible asset base relating to the IC and FM businesses. Given the importance of the capital base to the ROCE calculation, our view is that any analysis was unlikely to be robust enough for us to draw any conclusions from it.

Alternatives to ROCE

78. The Guidelines state that in situations where capital employed cannot be reliably valued, the CMA may consider alternative measures, such as the return on sales (ROS) or other relevant financial ratios. For instance, comparisons with businesses operating in different but similar markets may on occasion be helpful.[31]

79. We asked the parties what the best measure of profitability would be, if they considered that ROCE would not be appropriate.

[31] CC3 Revised, Annex A, paragraph 15

80. [✄] view was that ROCE was not an appropriate measure of profitability. [✄] told us that, in the normal course of business, it tracked direct margin and pre-tax income (PTI) for each of IC and FM and that these were therefore the best measures of performance. [✄] understood that the CMA was interested in estimating [✄] profits against a 'competitive benchmark' for the direct margin and PTI as % of revenues. [✄] understood that the ideal benchmark being sought by the CMA would be a business outside of IC that: sells to engaged and informed consumers, is subject to effective competition and is very similar in organisational structure to [✄]. [✄] told us that it had not yet identified a suitable benchmark.

81. [✄] told us that it did not have a recommendation for an alternative to ROCE at this stage, and that within its own business it had monitored the performance of net operating income (NOI). However, it stated that it recognised the limitations of this approach, for example the performance of another business/region could substantially affect the allocation of costs to the NOI, and in addition NOI did not account for capital employed.

82. [✄] told us that it had no clear view on the most appropriate alternative to ROCE. It suggested earnings before interest and tax (EBIT) margin: this measure avoided complications associated with measuring a capital base, but it would be necessary to identify a suitable benchmark to determine what level of profit is 'excessive'. [✄] also noted that IC was an industry with a large amount of heterogeneity: firms were highly differentiated, with some offering 'light touch' services, and others investing heavily in their knowledge and service offering to provide superior advice and allow clients to use more sophisticated investment strategies; therefore, it was very difficult to carry out a like-for-like comparison of fee levels and it would be inappropriate to benchmark all companies against the cheaper provider.

Margins analysis: net profit margins

83. Table 1 and Table 2 below set out summary financial information for the three largest providers of IC and FM services combined and for the three smaller providers of IC and FM services combined for 2016.

84. Overall, the aggregate net profit margin for IC and FM combined for the six providers in 2016 was [20% - 30%].[32]

[32] These figures are a weighted average margin, that is, total profits divided by total revenues for the six providers.

85. For IC, the aggregate net profit margin for the six providers was [20% - 30%] and [20% - 30%] for FM.

Table 1 summary financial information, three largest providers of IC and FM services combined, 2016

												£m
				[✂]				[✂]				[✂]
	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Revenues	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total costs	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Net profit	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Net profit margin %	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA from party responses to initial financial information request

Table 2 summary financial information, three smaller providers of IC and FM services combined, 2016

												£m
				[✂]				[✂]				[✂]
	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Revenues	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total costs	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Net profit	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Net margin %	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA from party responses to initial financial information request

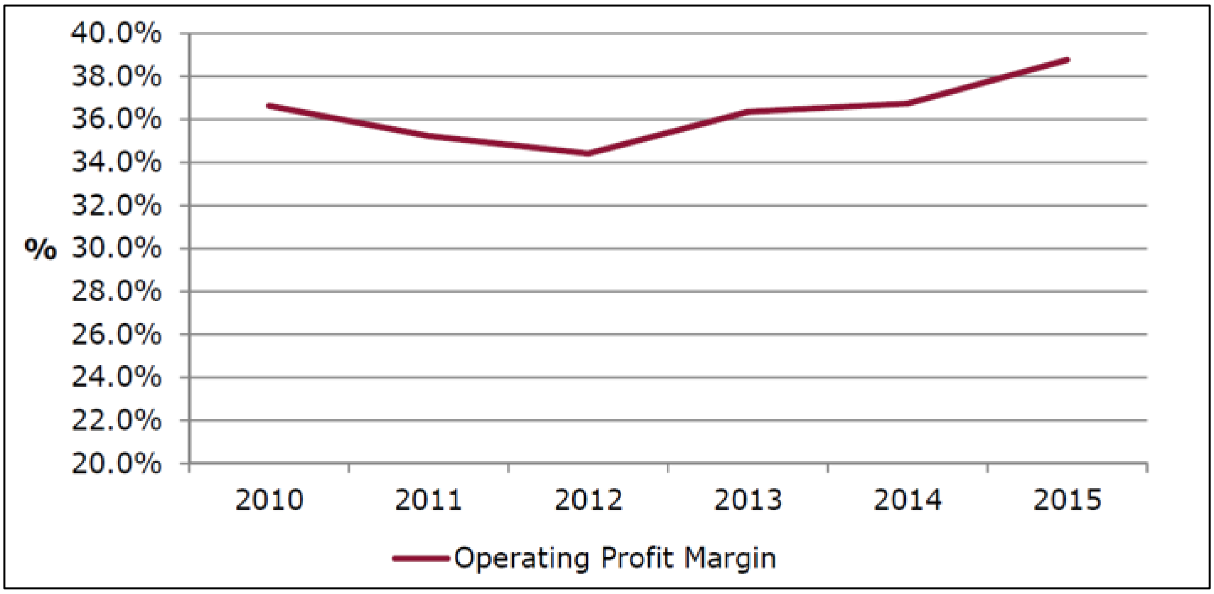
Profit margins of asset managers

86. We present here reported data on the profit margins of asset managers as we thought they were reasonably comparable: similar industry, parts of the same value chain, similar staff with a similar skill set and similar customers, high human capital and low tangible capital base.

87. As part of the FCA's asset management market study,[33] the FCA analysed profitability of asset managers. It looked at 16 asset management firms from 2010 to 2014 and 14 firms for 2015.

88. It found what it termed high levels of profitability, with average profit margins of 36% for the firms it sampled.

Figure 1: Operating profit margin



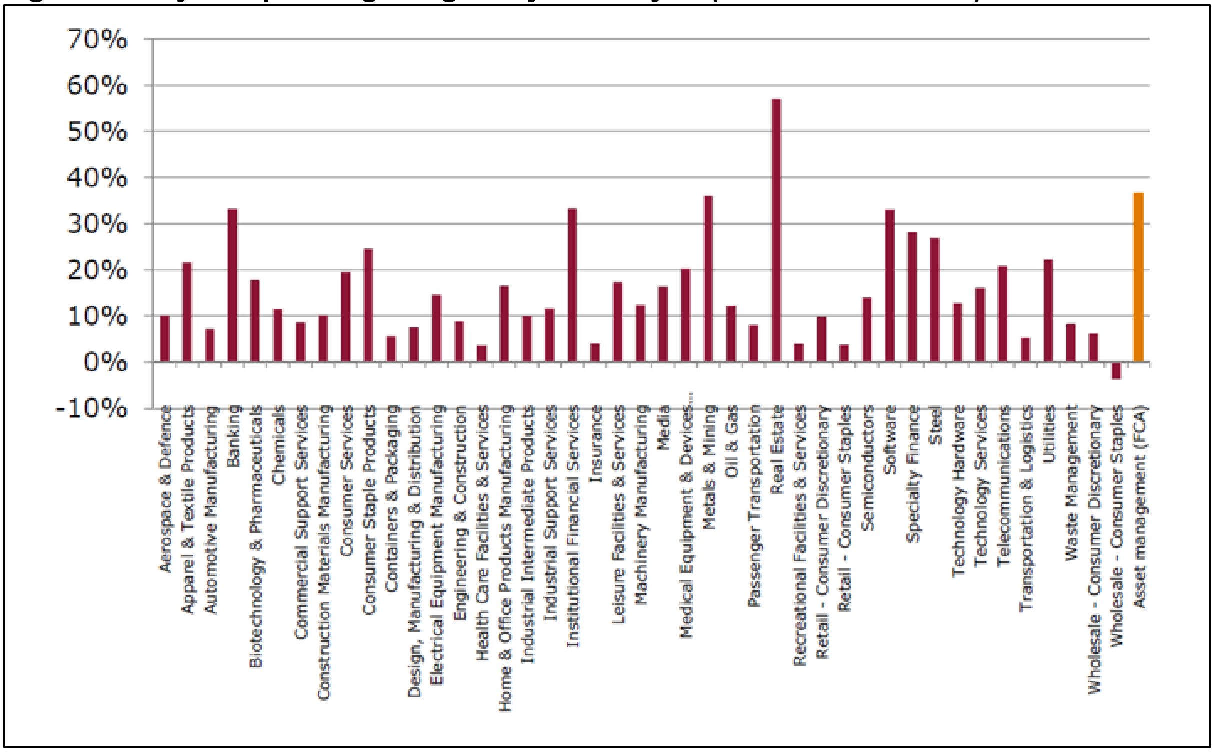
Source: FCA market study interim report, annex 8

89. It also compared operating margins for asset managers with operating margins of firms in the FTSE All Share (including asset manager firms) and showed that the average operating margin of these was around 16% with only one industry group achieving margins above the average margin found for asset managers. A comparison of industry groups in the FTSE All Share with similar business structures (high human capital, relatively low physical or financial capital) found margins in the 4 - 33% range. By comparison half of the asset management firms in the FCA's sample had an average operating margin above 30%. Three

[33] FCA Asset Management Market Study, final report June 2017

quarters of the asset management firms in the FCA's sample had an average operating margin above 20%.

Figure 2: 10-year operating margins by industry % (H2 2006 – H1 2016)



Source: FCA market study interim report, annex 8, from Bloomberg and FCA data

90. By comparison, the aggregate net profit margin for IC and FM combined for the six IC and FM providers in 2016 was [20% - 30%] ([20% - 30%] for IC and [20% - 30%] for FM). This is lower than the margins the FCA found for asset managers, but higher than the average operating margins in the FTSE All Share sample created by the FCA.

CMA emerging findings

91. We have found the following:[34]

(a) Overall, the aggregate net profit margin for IC and FM combined for the six providers in 2016 was [20%-30%]

(b) For IC, the aggregate net profit margin for the six providers was [20%-30%] and [20%-30%] for FM.

[34] All margin figures are for 2016

(c) These margins are lower than the margins the FCA found for asset managers, but higher than the average operating margins in the FTSE All Share sample created by the FCA.

92. It has not been possible to conclude whether profits are in excess of the cost of capital.