17 MAY 2018

CMA INVESTMENT CONSULTANCY AND FIDUCIARY MANAGEMENT MARKET INVESTIGATION

MERCER'S RESPONSE TO FINANCIAL PERFORMANCE AND PROFITABILITY WORKING PAPER

This is the response of Mercer Limited (**Mercer**) to the Financial Performance and Profitability working paper (**WP**) dated 26 April 2018.

1 Introduction and summary

1.1 We welcome the CMA's finding that an assessment of economic profitability of IC and FM providers would be disproportionate. As the CMA concludes, and consistent with our previous submissions on this topic, any reliable assessment of costs and capital employed in respect of IC and FM businesses would be highly challenging.

1.2 We particularly agree with the CMA's findings that:

(a) the construction of a balance sheet to measure assets employed by IC and FM businesses would be very difficult, time-consuming and resource-intensive, and subject to a high level of estimation;

(b) the difficulties associated with identifying and measuring intangible assets would make an assessment disproportionate; and

(c) a return on capital employed (**ROCE**) analysis would be too unreliable.

1.3 In addition, we believe the CMA underestimates the challenges associated with cost allocation, as a large proportion of the costs for our IC and FM businesses are allocated. This is explained further below.

1.4 In the absence of an analysis of profitability, we urge the CMA to approach any margin benchmarking exercise (particularly on the basis of a single year of margins data) with caution, as this is likely to give no more than indicative results. Further, we believe that the CMA has no basis for estimating detriment to customers in this market – in fact, as explained further below, the evidence is to the contrary: that IC and FM services bring positive benefits for pension schemes.

2 Cost allocation

2.1 The CMA states that it believes that cost allocation would not be a major hurdle to overcome in a profitability analysis.[1] Respectfully, we disagree.

2.2 As the CMA is aware, Mercer is a multi-disciplinary, multi-national firm, with many costs shared across business units and different locations. [✂].

2.3 As a result, our view is that cost allocation would be complex for individual firms, and even more complex to undertake on a reliable basis across IC and FM firms (with different structures and business models) and across time. Any conclusions on the basis of these assumptions would be unreliable.

2.4 We do not share the CMA's apparent confidence about the ease with which cost allocation could be dealt with if the CMA were to attempt a profitability analysis.

[1] WP, paragraph 69.

3 Responses to issues raised

3.1 We respond below to the specific areas on which the CMA has invited comments.[2]

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

3.2 As the use of cross-sector benchmarking of margin could itself be unreliable, this exercise would suffer from the same lack of reliability and would not allow for a "like for like" comparison.

3.3 In the WP the CMA uses asset management as a relevant comparator, with profit margins of IC and FM providers lower than those of asset managers (as calculated by the FCA). We do not have any immediate concerns regarding this comparison although we are unable to test the reliability of the underlying data and analysis.

3.4 In terms of further potential comparisons, Figure 2 of the WP shows 10-year operating margins by industry. Sectors with high human capital, and relatively low physical or financial capital – such as IC and FM – have a wide range of margins (between 4 per cent and 33 per cent). The average IC and FM margins identified by the CMA sit within this comparative range. However, to the extent that the CMA wishes to place any weight on these sectors for comparison, we would request that all supporting data used to calculate these margins be made public to allow for greater understanding and scrutiny.

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

3.5 As discussed above, the average range of IC and FM profit margins identified by the CMA is within the range of similar industries with high human capital and relatively low physical or financial capital. When compared with these industries the profit margins of IC and FM are not high.

3.6 In addition, we invite the CMA to consider comparisons against the value delivered by IC and FM services in terms of improving outcomes for pension schemes. [✂].[3]

3.7 This outperformance far exceeds our revenues from FM, and thus demonstrates that our clients receive clear value for money from our FM services. Indeed, in its working paper on the Competitive Landscape the CMA finds that the total revenues of the IC and FM markets are around £520 million.[4] A margin level of 20-30% would suggest total profits for the industry were in the region of £100 million - £150 million. The value added by Mercer's FM business in 2016 would exceed these annual industry profits even before accounting for cost of capital.

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

3.8 As we have previously submitted, we do not believe that there is a suitable alternative approach that would give the CMA reliability, stability and comparability of profitability figures.[5]

3.9 In this context, we do not consider a metric based on revenue per client presents an appropriate basis to assess financial performance of the firm. It does not account for the costs (including costs of capital employed and investment) involved in servicing that client. It is also not clear what benchmark the CMA could define and apply for revenue per client against which to assess the observed levels from IC and FM firms.

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2 WP, paragraph 7(a)-(d).
3 [✂].
4 £280 million p.a. for IC (para 70) and £237 million p.a. for FM (see Competitive Landscape working paper, paragraph 113).
5 [✂].

(d) Given that the CMA has not conducted a return on capital employed (ROCE) analysis, views on whether it should estimate any potential detriment

3.10 Our firm view is that, absent a robust and objectively verifiable evidence base, the CMA should not estimate any potential detriment. To do so in the absence of a ROCE analysis or equivalent risks reaching a finding that is unreliable and unfair.

3.11 Further, we are concerned by the CMA's suggestion that detriment in this sector could arise from either excess profits or from "*low quality advice provided by IC or FM providers resulting in poor investment decision by pension schemes*".[6] The CMA has not identified any evidence that advice in the IC or FM markets is of a low standard. On the contrary, we add significant value to our clients through IC and FM services – indeed, as noted above, our full FM clients have achieved significant outperformance as a result of our services. This is further reflected in the CMA's survey finding that 95 per cent of trustees are satisfied with their IC and FM providers.[7] As highlighted by the same results, these are highly qualified and sophisticated purchasers who can and do scrutinise quality of service and value for money.[8]

3.12 As a result, therefore, the combination of no evidence of excess profits (indeed, the limited evidence that exists suggests that profitability is comparable with relevant sectors) and positive evidence of good quality IC and FM services, should lead the CMA to conclude that there is no detriment to clients in this sector.

6 WP, paragraph 4.

7 CMA survey, page 14: for IC 57% of trustees are "very satisfied" and 38% "fairly satisfied"; for FM 59% are "very satisfied" and 36% "fairly satisfied".

8 See Mercer's response to the Trustee Engagement working paper.