Selling: Standard Life Aberdeen (SLA); FTSE 100; Financial Services

Managing a portfolio is a lot like managing a garden. In gardening there are regular recurring tasks such as trimming back fast-growing plants and replacing unattractive plants with more attractive alternatives. In a portfolio this means regularly trimming back oversized positions and replacing unattractive holdings with more attractive alternatives.

Average purchase price (including investment in Aberdeen AM)	Current price	Holding period
£3.76	£2.90	Feb 2016 to Apr 2021 (5yrs 2mo)
Capital gain (including return of capital from de-mergers)	**Dividend income**	**Annualised return**
-13.4%	31.2%	4.0%

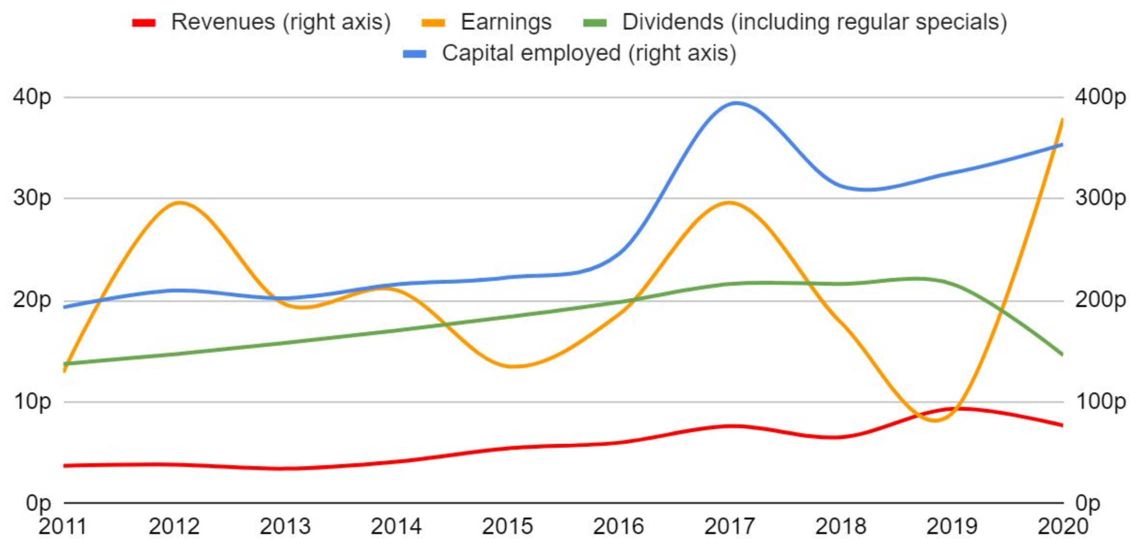
"Standard Life Aberdeen is one of the world's largest investment companies, the largest active manager in the UK and one of the largest in Europe. It has a significant global presence and the scale and expertise to help clients meet their investment goals."

Overview

Standard Life Aberdeen (SLA) originally joined the model portfolio in 2016 as Aberdeen Asset Management, which was then the second largest active fund manager in the UK (second only to Schroders). This investment worked out well, with the 2017 merger of Aberdeen and Standard Life leading to annualised return of 17% at the merger date.

I decided to hold on to the SLA shares post merger because Standard Life was a leading asset manager and the combined group promised additional economies of scale and a more diverse and robust business. Four years later and as a more experienced investor, I now think both companies lacked durable competitive advantages and I think that's true of the combined business too.

Price / Buy Price	Dividend yield	PE10	Growth rate	Growth quality
1.7 (max 2.0)	5%	13.9 (max 30)	6% (min 2%)	64% (min 75%)
Return on capital	**Return on sales**	**Debt ratio**	**Capex ratio**	**Acquisition ratio**
7% (min 10%)	36% (min 5%)	2.2 (max 4.0)	0.2% (low)	144% (max 100%)



Investment checklist (used for both buy and sell decisions)

*This investment checklist is designed improve the odds that the model portfolio only invests in quality companies and defensive companies trading at prices which represent good or excellent value. You can access the checklist template as a Google Doc here: **UK Value Investor Checklist**.*

Quality: Is this a quality company? NO

Q.1. Does it have a focused core business?

YES Standard Life Aberdeen's core business is active asset management, where most revenues are generated as fees charged on some £457 billion of assets under management (AUM).

These assets are managed for a variety of global clients, from governments to pension funds, insurance companies and individuals. The assets are spread across a variety of assets classes (equities, bonds, private equity, alternative assets) and strategies (e.g. active, quantitative, ethical, bespoke).

The company has £67 billion of client assets on its financial advisor platforms Wrap and Elevate. There's also another £13 billion of client assets held through its consumer-facing businesses, including 1825 (a financial advisor) and discretionary fund management services via Aberdeen Standard Capital. These businesses are small and they're not asset managers, but they're still core as they are additional channels through which SLA's core asset management business can gather new client assets.

Overall I would say that SLA has a diverse range of operations, but the vast majority fall within the normal range of asset management activities.

Q.2. Has it had the same core business for over a decade?

YES SLA has only existed for three or four years, so we need to look back at its two parent companies.

Ten years ago Aberdeen Asset Management (Aberdeen) was an asset manager and the Aberdeen of today (as it exists within SLA) is still an asset manager. Of course many of the details have changed, but the core business is still asset management for pension funds, life insurers, governments and other third parties.

For Standard Life (SL) the answer is also yes, but only just. Historically Standard Life was mostly a life insurer, and it wasn't until 2010 that it began reporting its results like an asset manager rather than an insurance company. It wasn't really until 2014 and 2015, when the company sold off its Canadian insurance business, purchased a UK asset manager and promoted the head of Standard Life Investments to CEO of the whole company, that the transformation from life insurer to asset manager was effectively complete.

Q.3. Has it had broadly the same goal and strategy for more than a decade?

YES From around 2015, the overarching goal of Standard Life (pre-SLA) was to turn itself into a world-class investment company. Before that its goal was focused more broadly on moving towards savings and investment products, but the direction of travel away from insurance and towards investment management was clear.

For Aberdeen the answer is simply yes, its goal has always been to be a pure asset manager.

As for strategy, there are two long-term threads from Aberdeen and Standard Life which continue today:

(1) Global expansion towards emerging markets: It's no secret that so-called emerging markets like India and China are seeing huge increases in middle class wealth, and every global asset manager worth their salt is looking to expand into those markets. Both Standard Life and Aberdeen have long had exposure to those markets, and the strategic importance of eastward expansion has only increased with the merger.

(2) Going beyond manufacturing components to providing asset class agnostic solutions: Somewhat oddly, asset managers are known as "manufacturers". They manufacture financial components like investment trusts and ETFs which both SLA and its clients use to build portfolios. Manufacturing and managing funds is still SLA's core business, but over the last decade this model has become problematic and it may even be in structural decline.

Part of this is down to the relentless rise of passive funds. Today, if a pension fund wants to allocate some of its assets to equities, it can easily invest in a virtually cost-free passive fund which tracks a benchmark such as the global equity market. Given the less than stellar performance of most actively managed funds, it's becoming harder for institutions and individuals to justify a significant allocation to actively managed assets.

But the decline of active funds isn't all the fault of passive funds. Component funds (funds that focus on a single asset class benchmark such as global equities or UK government bonds) are not always what clients want. What they want is an outcome, such as a stream of cash flows to pay pension liabilities as they come due, or assets which are virtually certain to cover life insurance claims today and decades into the future.

So rather than selecting from a set of component funds which then have to be bolted together, what many clients want is a single product that targets certain outcomes, such as a 4% cash yield growing ahead of inflation or a fund whose asset value grows 2% above inflation with little or no downside risk.

This can require investment in private markets, such as directly owned real estate (e.g. build-to-let housing or science parks) or venture capital investments in private companies. These "solutions" are more suited to active management than passive, and they tend to be higher margin too.

(3) Use scale to offset fee margin compression from passives: Competition from near-costless passive funds has been a major profit margin headwind for active managers in recent years.

One way to offset margin pressure is to gain additional economies of scale, and that was a major reason for the merger. Merging gave the combined companies the opportunity to strip out costs while expanding their product and geographic reach. The goal was to increase revenues and reduce expenses, which would hopefully improve profits even in a passive dominant world.

Q.4. Has it earned consistently good returns?

NO Again, SLA has only been around for a handful of years, so we need to look at its parents first:

Standard Life: After stripping out the life insurance business from Standard Life's results, it seems the remaining asset management business was producing mediocre results at best. In terms of profit margin the business was doing well, with margins very high at almost 40%. In terms of return on capital employed (ROCE), Standard Life Investments was struggling with ROCE rarely exceeding 10% in any one year.

This is not good because weak returns on capital are usually associated with weak companies that lack durable and affordable competitive advantages.

Aberdeen Asset Management: From 2007 to 2016, profit margins averaged 16%, which is good. ROCE averaged 10%, which is okay, although for a while (2011-2015) ROCE averaged a more impressive 15%.

SLA: Since the merger SLA's return on capital has averaged less than 7%, which is weak. Some of this has to do with the cost of Standard Life effectively acquiring Aberdeen, which lumped SLA with a near £4 billion intangible goodwill asset. That asset massively increased capital employed which has subsequently hurt ROCE, but that simply reflects the realities of the price paid for the merger.

Q.5. Has it produced consistent and sustainable growth?

NO In recent years SLA and its parent companies failed to produce consistent and sustainable growth.

Standard Life: SL's asset management business only began managing third party capital in 1998, so its track record is quite limited. Having said that, its growth was actually quite consistent and likely sustainable, although I'm sure it was helped by the existing relationships it had with Standard Life's life insurance and pension clients, in much the same way that Legal & General's asset management business has a symbiotic relationship with L&G's life insurance and pension businesses.

Before the merger Standard Life Investments had consistent positive net inflows of client assets, driving AUM growth. This is what every asset manager hopes for. But since the merger SLA has seen nothing but net outflows, with around 6% of AUM leaving the business per year, which isn't good.

Aberdeen Asset Management: Here the picture is even worse. As far as I can tell Aberdeen was losing client assets every year from at least 2011 until the merger, with 10% of assets leaving the company in both 2014 and 2015. This was largely offset by assets gathered through acquisitions, but making acquisitions to offset client outflows is not what you'd expect from a quality asset manager.

SLA: Post-merger, SLA's fee revenues have declined every single year, going from £2.1 billion in 2017 to £1.4 billion in 2020. Adjusted operating profits also declined over the same period from £0.5 billion to £0.2 billion. That decline left the dividend seriously uncovered, to the point where it was only affordable because SLA started selling off its Indian life insurance investment, freeing up almost £3 billion of cash. This lack of operational dividend cover is probably why the new CEO rebased the dividend to a more sustainable level.

Q.6. Has the company avoided the need for large transformation projects?

NO There are few projects more transformational than a merger, and few projects have more potential to go catastrophically wrong. That's why mergers should mostly only be used as a last resort, after a company has failed to grow by organic reinvestment of retained earnings, small bolt-on acquisitions or larger acquisitions.

The main reasons given for the merger were: (1) Increased scale to offset the profit margin pressure from passive funds, with SLA becoming the largest active asset manager in the UK and one of the largest globally; (2) increased breadth of products and services so it can better serve the diverse needs of larger clients; (3) increased geographic reach making it more attractive to global clients with global needs; (4) increased resilience through increased product, service and geographic diversity.

These are entirely sensible goals and I agree that they seem to be a good direction for both companies to go in. But the fact that they chose to pursue those goals through a merger suggests to me that both companies were willing to take on a lot of risk in an attempt to short-cut the evolutionary process.

A high risk merger certainly wasn't the only choice. If you look at Schroders it's facing virtually identical pressures and is pursuing very similar goals of increasing scale and robustness, moving away from beating benchmarks to providing solutions to complex client problems, and of course expanding eastwards.

But Schroders is using a strategy of organic growth and bolt-on acquisitions, rather than trying to do everything at once with a merger. Schroders is able to do this because it generates consistent double digit rates of return on capital. It then pays a conservative dividend, so it retains £100-200 million each year to invest in organic and bolt-on growth. It's willing to take a very long-term view, planting the seeds of future success by opening offices in markets that are potentially decades away from becoming developed enough to be worthwhile, building deeper local experience and relationships than more short-sighted peers.

That's a very different approach, but for a high quality company that doesn't want to dilute those rare characteristics that make it special, it's much preferable to a merger.

Q.7. Has the company avoided excessively rapid expansion?

NO SLA has been in decline since the merger, so excessive growth is not an issue. Standard Life's pre-merger asset management business grew quickly once it started managing third-party capital in 1998, but that was within a much larger parent company so I don't think its growth was excessive.

As for Aberdeen, it has a long history of rapid acquisition-drive growth. Acquisitions are the topic of the next question, so for this answer I'll focus on the pace of Aberdeen's growth and how that growth was funded.

From 2007 to 2016, Aberdeen increased its capital employed by about £1.9 billion. That's impressive, but it's even more impressive because it only retained around £170 million of earnings over that period.

So where did the rest of the new capital come from? The answer is a small increase in debt and a very large increase in the number of shares issued to shareholders, mostly through rights issues. For example, from 2011 to 2016 Aberdeen more than doubled its share count.

There are two main risks from such aggressive externally funded growth:

(1) The cash raised from shareholders won't be treated as carefully as cash earned through the daily grind of business operations, in the same way that people are more likely to waste lottery winnings compared to hard earned savings;

(2) Rapid growth means a lot more people, clients, relationships, systems, processes, hardware, software and so on, all of which needs to be well integrated to operate effectively and efficiency. In many cases excessive growth can stretch the fabric of a company to breaking point.

Whether or not this was the case with Aberdeen is hard to tell, but the fact that management were willing to repeatedly issue new shares to fuel rapid acquisition-driven growth suggests a culture that is not in line with the sort of steady low-risk organic growth that I'm looking for.

Q.8. Has the company grown organically rather than through acquisition?

NO A merger is effectively a huge acquisition, so clearly SLA has not avoided large acquisitions in the last ten years. And even if we ignore the merger, I've already said that Aberdeen had a history of making large acquisitions fuelled by debt and rights issues.

Aberdeen's acquisitions from 2007 to 2016 cost about 40% of total earnings over that period, which is a lot, and the acquisitions in three individual years cost more than that year's earnings. So there were multiple large acquisitions. More importantly, these acquisitions and the merger have been the main source of growth for both SLA and Aberdeen.

Q.9. Does the company benefit from network effects?

NO Network effects exist when customers are a key part of the service for other customers, as is the case with Rightmove, eBay, Facebook or telephones. This can be an incredibly hard advantage for competitors to overcome, but sadly for SLA it doesn't have any meaningful network effects.

Q.10. Does the company benefit from unique and hard to replicate assets?

NO I'm always tempted to say that a well know brand is a valuable, unique and hard to replicate asset, but most of the time it isn't. Truly valuable brands attract customers at higher prices or at lower costs than competitors, and they attract talented employees at lower cost and help retain them for longer too.

While Standard Life Aberdeen is a well known brand, I don't think it's attractive enough to give SLA a meaningful advantage over other well known asset managers. In fact, clients have said the company's multiple brands (Standard Life Aberdeen, Aberdeen Standard Capital etc) are confusing and the company is about to announce a new brand and perhaps a new name.

Beyond brand, I don't think SLA has any meaningfully valuable, unique and hard to replicate assets.

Q.11. Does the company benefit from core market leadership?

NO SLA's advisor platform businesses, Elevate and Wrap, are market leaders in the UK and are a useful way for SLA to hoover up assets from retail clients (you and me) into its funds. Eventually this could become a powerful form of vertical integration, similar to Legal & General's vertical integration from creating assets (e.g. building build-to-rent homes) to putting those assets into funds (e.g. a real estate trust) and then combining funds to create an asset-class agnostic outcome-focused solution for a pension fund client.

However, the advisor businesses only hold around 10% of the company's AUM, so although they're market leaders their lack of size means their contribution to the whole is limited. So although SLA benefits from this market leadership, it only benefits a little bit.

Also, post-merger SLA is now the UK's largest active asset manager, but it only got to that position thanks to the merger of two non-market leaders. Having said that, if the merger integration can be completed effectively and promptly then perhaps SLA's market leading scale will become a competitive advantage, but we won't know for sure until at least several years from now.

Q.12. Does the company benefit from switching costs?

NO There are definitely some time and money costs for clients when they switch to a new manager, such as vetting the new manager, selecting funds, negotiating and so on.

However, these costs haven't stopped Lloyds Banking Group from recently moving over £100 billion (over 15% of SLA's AUM at the time) away from SLA, with around £80 billion moving to Schroders as part of its Schroders Personal Wealth joint venture with Lloyds. So any switching costs are ineffective barriers to exit.

Defensiveness: Is this a defensive company? NO

D.1. Is the company's core market defensive?

NO SLA's core business is asset management, where it generates revenues and profits from fees charged as a percentage of client assets under management. Unfortunately for SLA, asset prices go up and down with the ebb and flow of the economy, and so do its fees, revenues and earnings. In addition, clients tend to add money to their investments during economic booms and withdraw during busts, and this only exacerbates the cyclical nature of asset managers.

D.2. Is the core market expected to grow over the next ten years?

YES The world is slowly becoming richer, with hundreds of millions of people set to become middle income earners over the next few decades. These middle earners will increasingly want health insurance, life insurance, pensions and long-term savings, so despite the relentless advance of passive funds, there are likely to be plenty of growth opportunities for global active asset managers for a very long time to come.

D.3. Is the core market relatively free from regulatory risk?

NO Financial services is a heavily regulated industry and those regulations have a nasty habit of changing frequently and sometimes abruptly. I don't see this as a particular problem for well established companies like SLA, but it's certainly a negative factor and something to be aware of.

D.4. Is the core market unlikely to be disrupted?

NO Active asset management is being disrupted by a combination of near-zero cost passive funds and technology which makes it easier for institutional and retail clients to self-build well designed portfolios. There are various ways active managers are trying to cope with these threats, two of the main ones being:

(1) Scale: Because of the zero lower bound for fees (passive fees can only go to zero, unless someone works out a way to have negative fees and generate revenues by selling client data), active managers with enough scale may be able to operate with low enough fees (say 0.25%) such that investors will still invest with them because of the potential for outperformance and near passive-level fees.

(2) Private markets and outcome-oriented solutions: These are things that passive doesn't do well. Passive funds can't create their own private income-generating assets in the same way that (for example) L&G can by funding or directly creating build-to-rent homes using its CALA Homes subsidiary, which can them be slotted into an income-generating real estate trust. And passive funds can't manage assets to a specific outcome such as a 4% yield growing with inflation or a 4% total return with near-zero downside risk.

Active managers can't guarantee those returns, but they can get a lot closer than a passive fund following a mechanical algorithm.

Having said that, the industry is still being disrupted, and the SLA merger only happened because of that disruption, so it's clearly a serious problem.

D.5. Is the company free from significant concentration risk?

NO I tend to feel uncomfortable if a company generates more than 10% of its revenues and/or profits from a single customer. And as I've already mentioned, SLA recently lost around £100 billion (about 15% of its AUM) when Lloyds chose to partner with Schroders instead. So SLA had around 15% of its assets with a single client (Lloyds), which was a ticking time bomb that eventually exploded.

More worryingly, SLA has £148 billion (27% of its AUM) with Phoenix Group. These assets form part of a long-running partnership between the two companies, part of which involved Phoenix acquiring Standard Life's UK and European life insurance businesses in 2018.

The current agreement was recently extended to 2031, so the assets are likely to stay with SLA until then. But then again perhaps not, as Lloyds withdrew £100 billion of assets from SLA before its contract ended in 2022, and paid £140 million for the privilege.

So there is no guarantee that Phoenix won't withdraw its £148 billion before 2031, and definitely no guarantee that it won't withdraw them in 2031 or soon after. That's a whopping 27% of SLA's assets under management, which would be a catastrophic blow if Phoenix switches to another manager.

D.6. Is the company free from significant product or patent risk?

YES SLA was over-exposed to certain "hero funds" which have underperformed in recent years, so it does have some degree of product risk. Overall though, I don't think its exposure to a single fund or fund manager is excessive.

D.7. Is the company largely unaffected by commodity prices?

YES SLA is not heavily exposed to commodity prices or commodity-related investments.

D.8. Does the company have prudent financial liabilities?

YES SLA has total debts (borrowings plus lease liabilities) of just over £1 billion while its average earnings over the last decade are around £0.5 billion, and that excludes the earnings of Aberdeen Asset Management. So the Debt Ratio is just over 2 at most, which is relatively prudent.

Value: Is this company good value? NO

V.1. Is the company free from problems which are likely to materially damage its long-term prospects?

NO SLA has some major problems, there's no doubt about that. Looking at the overall results of Standard Life, Aberdeen and SLA, there have been net client outflows in every one of the last seven years. Fee based revenues and operating profits have declined every year for four years. The dividend was uncovered by operating earnings every year since the merger. Lloyds decided to take £100 billion elsewhere. Passive funds are growing and compressing fee margins. Integration of the two parent companies is still ongoing.

Of course, these problems don't necessarily mean that SLA is about to collapse or that it can't turn things around and prosper. But having to deal with so many material problems at the same time is a serious risk, and if the merger doesn't go well or if it can't stem the outflow of client assets, it could materially impact the company's future.

So to err on the side of caution I will assume these problems are likely to materially damage SLA's long-term prospects.

V.2. Is dividend growth very likely over the next ten years and beyond (and how much)?

NO Now that the dividend has been rebased to a more sustainable level I think dividend growth over the next decade is quite likely. As long as SLA doesn't become a complete basket case there's room to grow the dividend under a wide range of reasonable expectations.

However, beyond the next ten years I am more cautious. SLA doesn't have any enduring competitive advantages as far as I can see, so I have to assume it goes into long-term decline beyond the next ten years, as that's the fate of most companies (at least it is for those that don't go bust or get taken over).

This is reflected in my dividend discount model for SLA, which has slow but steady dividend growth over the next ten years followed by a decline of 2% per year beyond that.

Dividend Discount Model (GBP)	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030+
Estimated net return on capital	*7.8%*	*7.8%*	*7.7%*	*7.6%*	*7.5%*	*7.5%*	*7.4%*	*7.3%*	*7.2%*	
Estimated earnings ps	27.7	28.4	29.1	29.7	30.3	30.8	31.3	31.9	32.4	
Estimated dividend cover	1.9	1.8	1.7	1.6	1.6	1.6	1.6	1.6	1.6	
Estimated dividends ps	14.6	15.8	17.2	18.6	19.0	19.3	19.6	20.0	20.3	166
Estimated capital employed ps	366	379	391	402	413	425	436	448	460	
Discount factor	*91%*	*83%*	*75%*	*68%*	*62%*	*56%*	*51%*	*47%*	*42%*	*39%*
Discounted dividends	13.3	13.1	12.9	12.7	11.8	10.9	10.1	9.3	8.6	64.0
Estimated growth rates	ST growth	*4.2%*	LT growth	*-2.0%*	Target rtn	*10.0%*	Buy Price	167	Price / BP	**1.7**

V.3. Are the risks and expected returns from this investment satisfactory?

NO There are two reasons why I don't think the potential risks and returns of SLA are satisfactory.

First, the company doesn't meet my Quality or Defensive criteria. The Quality criteria is most important because non-Quality companies are just too uncertain and have no place in a defensive value portfolio.

Second, SLA's share price doesn't meet my Value criteria given the assumed dividend growth and decline in its dividend model. The Buy Price is £1.67 and the share price of £2.90 is 74% above that, giving the company a Price to Buy Price ratio of 1.7, which is closer to the Sell Price than the Buy Price.

Final Decision: Are you happy to own this company at this price?

NO SLA isn't a terrible company, but it isn't Quality, Defensive or good Value by my criteria, so on that basis I would rather sell it and reinvest the proceeds into more attractive existing holdings. I will therefore remove SLA from the model portfolio and my personal portfolio a few days after this newsletter is published.

Other potential sales	Reason for not selling
Petrofac	Lacks Quality and Defensiveness so I expect to sell it soon.
XP Power, Burberry, Next	These are potential sales because of their elevated share prices. However, they are all Quality companies so I'm in less of a rush to sell.