Merger review: Standard Life (SL.)

Aberdeen Asset Management (one of the model portfolio's holdings) recently merged with Standard Life to create Standard Life Aberdeen (SLA). I think now is a good time to review Standard Life so that we have a reasonable understanding of this new addition to the portfolio. The table below shows the figures for Standard Life, just before the merger took place.

Pre-merger price (01/08/2017)	Index	Sector
433p	FTSE 100	Life Insurance
Market Cap	**Net Asset Value**	**Normalised Post-tax Profit**
£8.6 billion	£220 million	£406 million

"Our simple business model is designed to help us generate value over the long term. We manage, administer and advise on assets for customers and clients and our businesses are focused on meeting their investment needs." (www.standardlife.com)

Overview

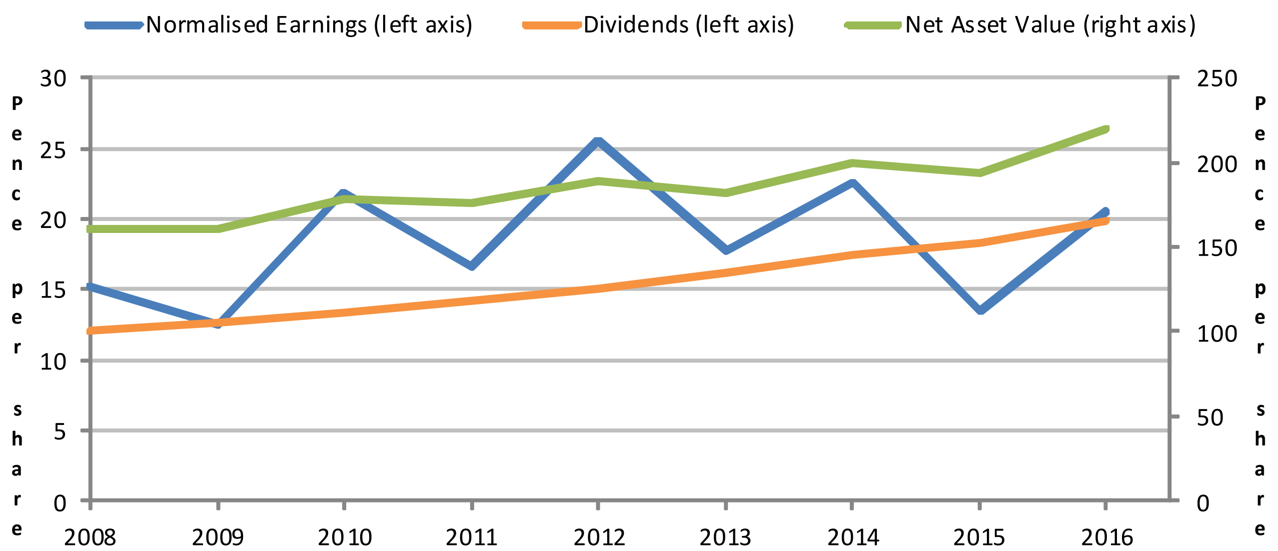
Standard Life started out as The Life Insurance Company of Scotland, way back in 1825. The name was changed to The Standard Life Assurance Company in 1832 and in 1925 the company became a mutual company, owned by its policyholders. By 1950 it was Scotland's largest life assurance company and by the 1990's it was Europe's largest mutual company.

In 1998, Standard Life launched an investment management business to build upon capabilities developed after decades of managing insurance premium assets. By 2008, Standard Life had begun to describe itself as an asset managing business and today the transformation from life insurer to asset manager is virtually complete, with the company's stated goal being to *"to create a world-class investment company: a global business that manages, administers and advises on investments for our customers and clients"*.

As an investment manager, Standard Life was very successful. Assets under management grew from less than £40 billion in 2006 to more than £350 billion today. Combined with £300 billion looked after by Aberdeen, the post-merger Standard Life Aberdeen will be the UK's largest active asset manager.

Dividend Yield	PE10	Growth Rate	Growth Quality	Profitability
4.6%	23.5 (max = 30)	5.3% (min 2%)	71% (min 50%)	9.7% (min 7%)
Debt Ratio	**Pension Ratio**	**Premium/Surplus**	**Acquisition Ratio**	**Rank**
1.3 (cyc. max 4)	7.6 (max 10)	0.8 (max 2.0)	21% (max 100%)	110 (out of 222)

Green = Better than FTSE 100; Pink = Worse than FTSE 100; Red = Outside the "rule of thumb" minimum or maximum values



Investment checklist

Successful investing requires the methodical application of a systematic approach in order to achieve specific objectives, and a checklist is a great aid towards that end. This checklist helps to ensure that the company under investigation is high quality and that its shares are likely to improve the portfolio in the long-run.

Maintaining and increasing portfolio diversification

1. Will this merger leave the portfolio's UK revenues at less than 50%?

YES Standard Life generated around 80% of its operating profits from the UK, so the merged company will tilt the portfolio very slightly towards the UK, but won't take its UK exposure beyond 50%.

2. Will this merger leave the portfolio's cyclical sector holdings at less than 66%?

YES The combined company is cyclical, as was Aberdeen, so this merger will have no impact on the portfolio's cyclicality.

3. Will this merger leave the number of holdings from this sector at three or less?

YES With SLA in the Life Insurance sector, there will now be two life insurance companies in the portfolio.

Avoiding value traps

Good management

1. Does the company have an obvious and dominant core business?

YES Standard Life's core business was asset management and operationally it was divided into two business units: Asset Management and Pensions & Savings. The asset management business managed assets directly for institutional investors or via funds for retail investors. The pensions and savings business managed pensions & savings products for employees or individuals, and also included a financial planning business.

In recent years the life insurance business had effectively become non-core and legacy, with little in the way of new policies being written. The most active part of the life insurance business was in India and China, although those were still relatively small compared to the overall group.

Since the merger with Aberdeen, Standard Life Aberdeen has become even more focused on asset management and many analysts think the insurance business will be sold off sooner rather than later.

2. Does the company have a clear and consistent goal and strategy?

YES Standard Life's goal was to be a world-class investment company, managing, administering and advising on assets for customers and clients.

The company's high level strategy was also incredibly simple: 1) increase assets under management, 2) maximise fee-based revenue, 3) lower costs, 4) maintain a strong balance sheet. This has to be the mantra for all sensible asset managers. However, more recently the company had also started to focus on diversification as a core strategy by: 1) Increasing the number of funds and the asset classes and objectives they cover, 2) generating fee-based revenues from a wider range of countries, distribution channels, asset classes and client types. This push for diversification will hopefully create a business which is more resilient against the ups and downs of the market. It's also a major reason for the merger with Aberdeen.

Adequate financial control

3. Do the Key Performance Indicators (KPIs) focus on factors beyond revenue and EPS growth such as profitability, leverage, liquidity and capital investment?

YES KPI's include measures of profitability such as operating return on equity and cost/income ratio.

Low costs

4. Scale: Is the company in the leading group in terms of market share?

YES Standard Life was already one of the UK's largest active asset managers. Post-merger, Standard Life Aberdeen will be the UK's largest and the second largest in Europe, based on funds under management.

5. Experience: Has the company had the same core business for many years?

YES Following the launch of Standard Life Investments in 1998, asset management became more and more important until it overtook life insurance to become the company's core business.

Caution with big projects

6. Is the company free of major projects which could push it into a crisis?

NO I would class this merger as a major project, capable of pushing the company into a crisis if it went badly wrong.

7. Has the company avoided dangerously large capital expenditures (capex)?

YES Asset management and life insurance do not require large capital investments. This shows up in the capex/profit ratio,which is 22% (below 50% is low), and the capex/depreciation ratio, which is 88% (below 100% is low).

8. Are revenues generated by the sale of a large number of small-ticket items rather than large-ticket items or major one-off contracts?

YES Revenues are generated primarily as relatively small recurring fees on the assets of thousands of customers.

Caution with acquisitions and mergers

9. Has the company avoided mergers or large acquisitions in the last few years?

NO If the merger was an acquisition then Standard Life would have paid almost £4 billion for Aberdeen. That would be an acquisition ratio of nine (nine-times the company's five-year average profit). My definition of a large acquisition is an acquisition ratio of one, so this is a huge business combination. Large combinations can be disruptive to both businesses as they are integrated and as layers of duplication are removed.

10. Has the company avoided large acquisitions that have little to do with its core business?

YES The merger is between two asset managers, so their core businesses are very similar.

Ability to adapt to changing market demand

11. Does the company operate primarily in defensive markets?

NO Most of Standard Life's fees were small and recurring, which are defensive characteristics. However, most of those fees were charged as a percentage of assets under management, and assets under management depend on investor sentiment and market valuations, both of which can be highly cyclical. In fact, there can be a "double whammy" of cyclicality because falling markets reduce assets under management (AUM), and falling markets lead nervous investors to sell, thereby further reducing assets under management. More positively, this feedback loop works to boost AUM when markets are rising.

12. Does the company operate in markets where the pattern of demand (whether cyclical or defensive) is unlikely to be disrupted in the short or medium-term?

NO The pattern of demand for pension, savings and investment products in the UK has seen many changes in recent years, such as the introduction of pensions auto-enrolment for employees and pension freedoms (i.e. the option to remain invested rather than buying an annuity) for pensioners.

For me the most important shift in recent years has been the increasing preference for passive investments. Vanguard, the largest passive asset manager in the world, is the best example of this change. Somewhat astonishingly, Vanguard's 2016 net fund inflow (i.e. all money in minus all money out) was larger than that of every other fund manager in the world, combined. The company now has more than $4 trillion of assets under management, the vast majority of which are in passive funds.

As an active fund manager, Standard Life was on the wrong side of this disruptive trend. In fact Vanguard's success is, I think, one of the main reasons why this merger makes sense. Passive funds are cheap, so active funds have to get cheaper to compete, and the easiest way to get cheaper is to increase scale.

But an endless shift towards passive investments is not inevitable. Passive funds have attracted investors in recently years partly because market indices have done well as they recovered from the financial crisis. Going forwards, things may be very different. With many markets now expensive rather than cheap, medium and even longer-term returns for those indices could be below average. So what do passive investors tend to do when the indices they follow perform badly? They look to active management that has outperformed. So the swing to passive investing may be cyclical rather than permanent, although personally I think it's a bit of both.

13. Does the company operate in markets where demand is expected to grow?

YES The demand for investment, pensions and savings products is expected to grow in line with population growth and the increasing need for retirees to build their own pensions rather than rely on the state. Standard Life also thought that active investment managers could do well in a low inflation, low growth world.

Competitive product, service and price

14. Has the company avoided generating a significant portion of its profits from a single product line or contract that needs to be replaced within the next ten years?

YES Standard Life generated revenues from relatively small recurring fees on dozens of different products and services, including investment funds, investment platforms and its financial advice businesses. None of these need to be "replaced" within the next ten years.

15. Does the company provide differentiated products/services that do not compete purely on price?

YES Active fund investors are more interested in total performance than they are in fees. So as an active fund manager, Standard Life's funds competed on performance rather than on price. However, performance is a very unreliable form of differentiation because consistent outperformance is virtually impossible. A more consistent differentiating factor is the company's name and reputation, which have been built over 200 years.

Indifferent to commodity prices

16. Is the company relatively immune to commodity price movements?

YES Although Standard Life did manage investments in commodities, they are relatively small.

Sound financial policy

17. Does the company have a target rate of return on investment of more than 10%?

YES Return on equity was a key performance indicator and a factor in the company's bonus scheme. The minimum level for a bonus payout to directors was 10.7% in 2016 (actual operating ROE was 14.5%).

18. Is the company's use of leverage conservative enough given the preceding answers?

YES Standard Life was not a heavily indebted company, with less than £600 million of borrowings compared to average post-tax profits of £440 million. This gave the company a debt ratio of 1.3, well below my preferred limit of 4.0 for cyclical stocks.

Slightly more worrying was its defined benefit pension scheme, which is very large at £3.3 billion, or some 7.6-times average profits. This gave the company a combined debt and pension ratio of 8.9, which is quite close to my limit of 10. However, the pension has a surplus of just over £1 billion, so the scheme is exceptionally well-funded.

19. Are the chances of this company becoming a value trap acceptably low (and if so, why are the shares attractively priced)?

YES I don't think Standard Life was an obvious value trap, partly because it wasn't exceptionally good value to start with, given its pre-merger rank of 62. However, a rank of 62 is still above average so I do think the company was somewhat attractively valued. In August, for example, the company's yield was 4.6%, so investors were far from universally positive about the company's ability to grow its dividend.

Also, the shares have bounced around from a high of over 500p in 2015, down to a pre-Brexit low point below 300p, followed by a recovery to just over 400p today. It's not entirely obvious why there's so much volatility, other than the manic nature of Mr Market. The company had been suffering net fund outflows recently (i.e. more money being taken out of its funds than put in), so that's a negative point. But I see that as just the cyclical ups and downs of a cyclical company, rather than a sign of a fatal flaw in the company's abilities.

Uncovering competitive advantages

1. Does the company have any intangible asset advantages (brand names, patents, regulatory barriers)?

YES The Standard Life name and its 200-year history are its primary intangible assets.

2. Does the company gain an advantage from "switching costs", i.e. the effort required for customers to switch to a competitor?

NO Fund investors can switch to a competitor's fund with relatively little effort. Customers who use Standard Life's investment platforms, financial planning services or life insurance and annuity products may have more trouble switching, but I'll answer this question "no", just to be on the safe side.

3. Do the company's products or services have a "network effect", i.e. become better as more people use them (e.g. Facebook, eBay)?

NO Standard Life's products may become cheaper as more people use them, thanks to economies of scale, but its services or products themselves don't become significantly "better" just because they're widely used.

4. Does the company have any durable cost advantages (e.g. unique location, unique low cost source of raw materials, greater scale)?

YES Standard Life was already one of the largest asset managers in the UK, and scale is a massive cost advantage in the asset management industry. The post-merger Standard Life Aberdeen is now the UK's largest active fund manager and the second largest in Europe, which should give it a durable cost advantage over European competitors.

Making the trade - Are you happy to own these shares for at least 5 years?

YES Although the merger between Standard Life and Aberdeen has lowered the rank of the holding that used to be Aberdeen, this is largely because the historic data is that of Standard life rather than the combined company. Once new annual results start to come through for the new company, I expect the stock's rank to improve, all else (including the share price) being equal. On that basis then, plus the fact that I'm quite comfortable being invested in both Standard Life and Aberdeen, I have no intention of selling the shares despite their current low rank, and I would be happy to hold these shares for at least five years.