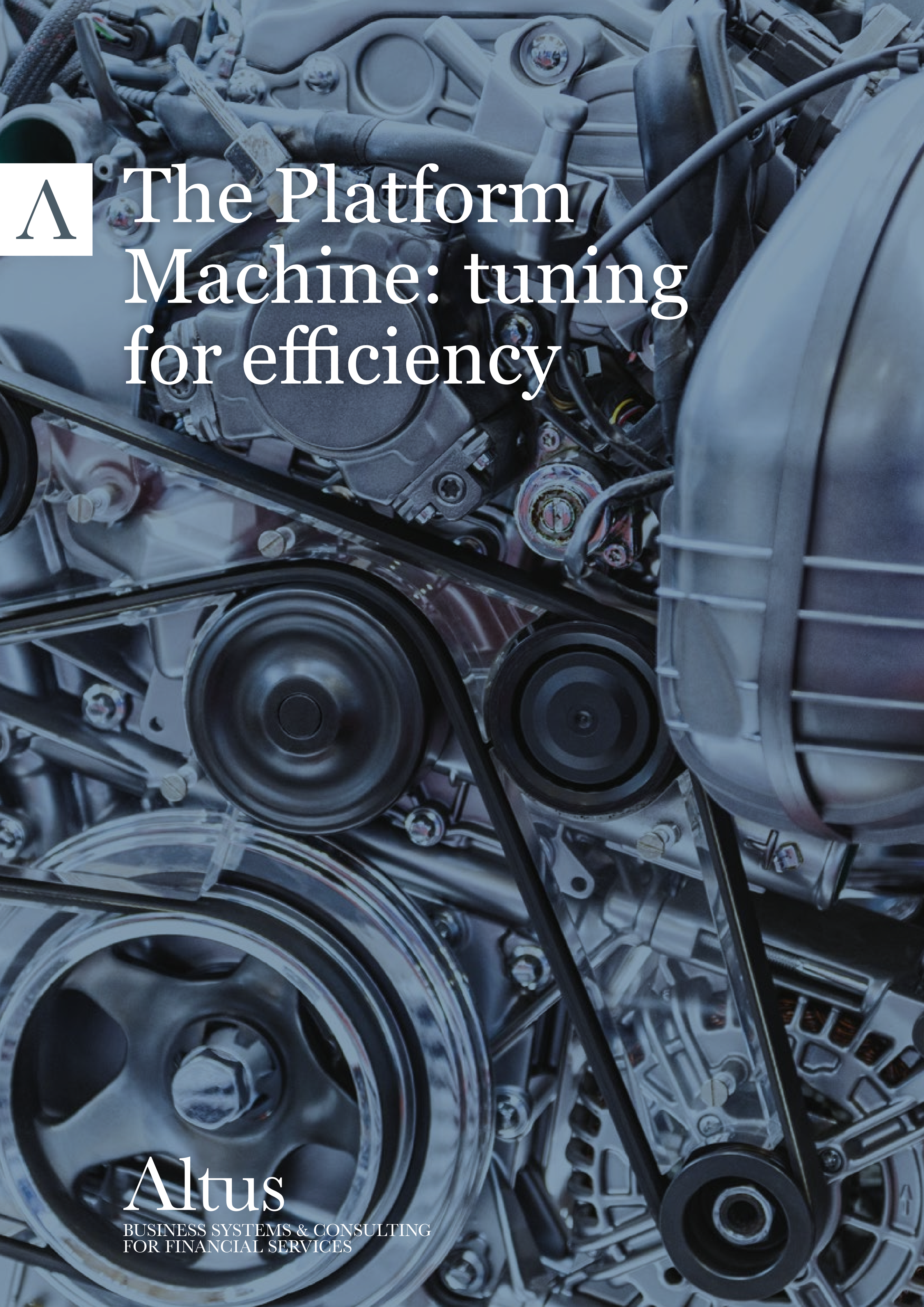

The Platform Machine: tuning for efficiency

Altus

BUSINESS SYSTEMS & CONSULTING
FOR FINANCIAL SERVICES

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The Platform Machine:
tuning for efficiency

Looking from a macro perspective, few would argue with the fact that platforms have been the great success story of UK investments in recent years. Over the same period that FSA product sales data charted a 50% decline in investment volumes, platform assets under administration (AUA) have increased by a factor of five. Every month another platform hits the news with the latest asset record and across the sector AUA now stand at over £244bn.

And, despite regular predictions of consolidation, new entrants continue to appear. Definitions vary but most commentators agree there are now more than 30 players in the platform market.

Between 2006 and 2011 platform AUA increased five-fold

Platform revenues grew from £330m to £740m

Average revenue per £AUA fell from 80bps to 40bps

INDUSTRIAL UNREST

'An industry held hostage by an untethered cost base.'

Sadly the truth behind the headlines presents a rather bleaker picture – one of waste, inefficiency and a failure by much of the platform industry to generate any real economies of scale.

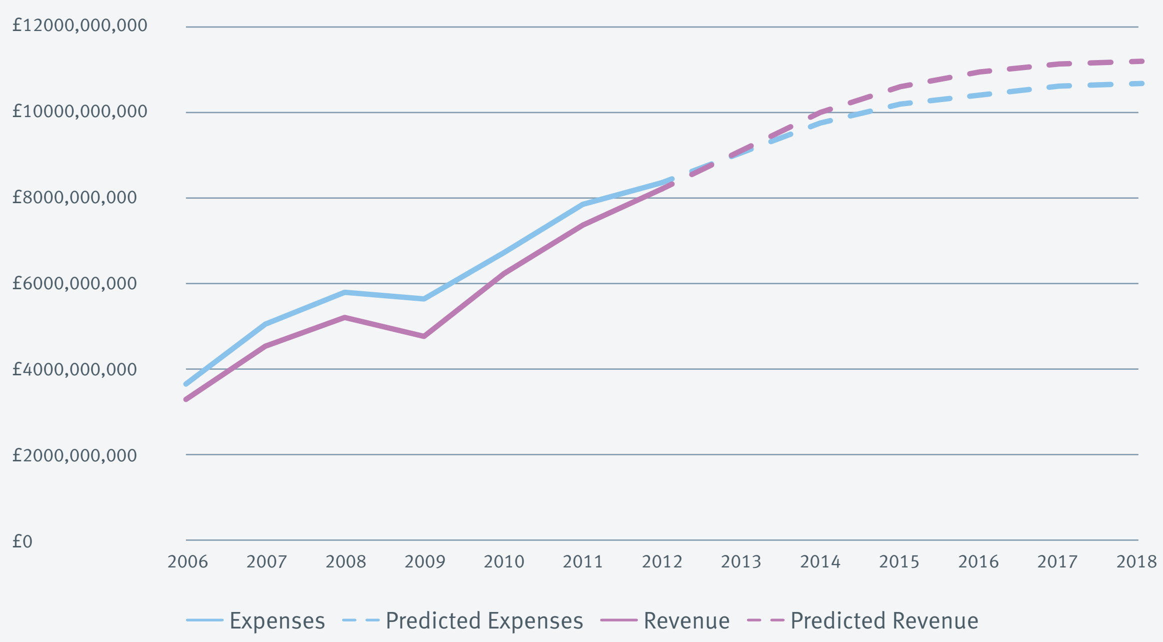
In 2011, according to their filed accounts, the top 20 platforms (by AUA) increased combined total revenue to over £740m. Contrast this with total expenditure for the same period of almost £790m and we see an industry allowing itself to be held hostage to a cost-base which is not only neglected but quite probably untethered and likely to gain momentum.

Obviously it would be wrong to afford sweeping blame across all the players in what is an aggregated model and indeed there are several platforms which have made a profit, but what this simple macro analysis demonstrates is that there has been so much emphasis on asset gathering and growing the top line that the bottom line neglect is now painfully obvious.

Whilst in other industries we often see substantial capital costs up front, these are invariably followed by much lower ongoing marginal costs; once the revenue and expenditure lines cross, firms quickly move into healthy profit.

To date though there is little evidence of this kind of rapid convergence in the platform industry. Since 2006, total costs for the top 20 platforms have remained consistently around 10% higher than the corresponding revenue figure — see figure 1.

Figure 1: Platform income and expenses



There is little sign of the revenue curve coming to the rescue thanks to a trio of price pressures:

- New platforms continue to emerge and there are now three times as many as in 2005; the competitive impact is plain to see in the wave of re-pricing announcements we have seen over the past 6 months
- The RDR rebate ban has now been formalised in PS13/1 and the revenue levels of bundled models will come under serious pressure when translated into explicit charges
- A significant portion of the increase we see in AUA is from institutional assets which are serviced at a fraction of the price of retail business

Effective yield on platform AUA has already halved (from 80bps to 40bps) between 2006-2011 and looks set to fall further still as price competition intensifies.

Any platform looking to improve profitability by translating scale into economies must therefore take rapid action to address the obvious commercial ramifications of this worrying trend. This will require a cradle-to-grave style approach to identify the danger areas and allow mplementation of swift remedial action.

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Audit - An Engineer's Approach

"The solution may well come down to effective reverse-engineering."

Fixing this misfiring machine requires engineering discipline.

Unfortunately none of the current crop of platforms comes with a 'Haynes Manual' and with most built on a bespoke basis, like a limited edition or a specialist kit car, just how do you create that simple cut-away model to see the moving parts of the business? For some the challenge may well come down to one of effective reverse-engineering; cataloging and categorising the machine they have already built.

There are three distinct perspectives to consider:

Capability

WHAT are the component parts of your platform?

Process

HOW do those components work together to deliver a service?

Organisation

WHO operates each process and where?

Consistency is essential; a good model must be comprehensible not just to those who built it but to those who will use it, change it and ultimately build on it. The best way to ensure this is via a structured, repeatable technique that can be explained, executed and challenged by different people across the business.

Unlike cars, investment platforms do not control the flow of fuel, sparks or brake fluid. What they do manage is the flow of information and an appropriate methodology to model platforms depends on rigorous techniques to analyse those flows.

The resulting model should include a comprehensive inventory of all the external organisations and individuals a platform interacts with, all significant information flows to and from them and a levelled hierarchy of business capabilities which deal with each type of in formation. A 'Haynes Manual' for the platform in fact.

At what cost?

'With no single benchmark platform the technology landscape involves significant complexity.'

Having built a clear picture of the individual components that make up a platform, the next step is to understand where the costs originate – which can often be much harder than it sounds. Few platforms can honestly say they understand their costs in detail and some would even query the value of doing so. But when you consider one platform administers £2m per employee on average whilst another manages £70m per employee, it certainly suggests that lessons can be learnt from closer scrutiny.

To get a more precise view of the key areas of cost across a business will require some careful consideration but in most cases need not be too onerous. With a sound modular approach and knowledgeable resources it is possible to build an accurate picture in weeks rather than months.

The input required is unlikely to be trivial and experience shows that some costs are more difficult to attribute to capabilities than others. Different platforms embrace different resource models but whilst the 'Corporate Actions team' and the 'Transfer Desk' probably do what they say on the tin, the situation might not be so straight-forward for 'Customer Servicing' or 'Technical Support'.

Talking to cost-centre owners about actual expenditure using a clear model, can quickly apportion most costs to a useful level of detail. However, to really drive decision-making, you need to know a bit more about the nature of those costs and the variables which affect them.

There are three basic categories:

- Volume dependent
- Overhead
- Complex

For example, adding a new fund to a platform might have been costly historically due to high rework levels but is likely to happen relatively infrequently. Fund distributions, on the other hand, are typically expensive due to volumes, which increase in line with both the fund range and number of customers.

Regulatory compliance costs meanwhile are likely to be relatively high for smaller platforms but should increase more slowly than other expenses.

The most complex costs to understand are inevitably in IT. There is no single platform system and the technology landscape of most participants involves significant complexity. Understanding what the various components of the technology landscape do and the total cost of ownership is paramount to improving efficiency.

Allocation of IT costs requires 'bottom-up' analysis of the applications they relate to, the capabilities these applications support and it must ultimately reconcile back to real budgets.

The result of all this analysis is a rich model of the componentsof a platform, their individual cost parameters and triggers as well as the connections and dependencies between them. Having completed the full reconnaissance stage it is then possible to progress to diagnosis.

Fast Facts

IT'S ALL ABOUT SCALE

£70m

The highest average AUA administered per platform employee

£2m

The lowest average AUA administered per platform employee

Thermal Imaging - Identification of cost 'hot-spots'

> **"Much more componentisation of platforms expected."**

Considerable experience in complex financial modelling has confirmed the importance of clear visualisation as a central tenet to good decision-making. It may seem obvious but presenting a simple one-page picture of the cost 'hot-spots' within a business can bring key issues to life and really focus attention – see figure 2 for an example.

Figure 2: Operating cost heatmap

There are a range of options for improving efficiency and figure 3 shows the results of a recent Altus poll on how platforms expect these to develop.

The precise prescription will vary from one business to the next but understanding the options available is a vital step in progressing from audit to implementation, allowing strategic commercial decisions to be made and their potential outcomes modelled.

Which of the following do you expect to have most impact on reducing operating costs?

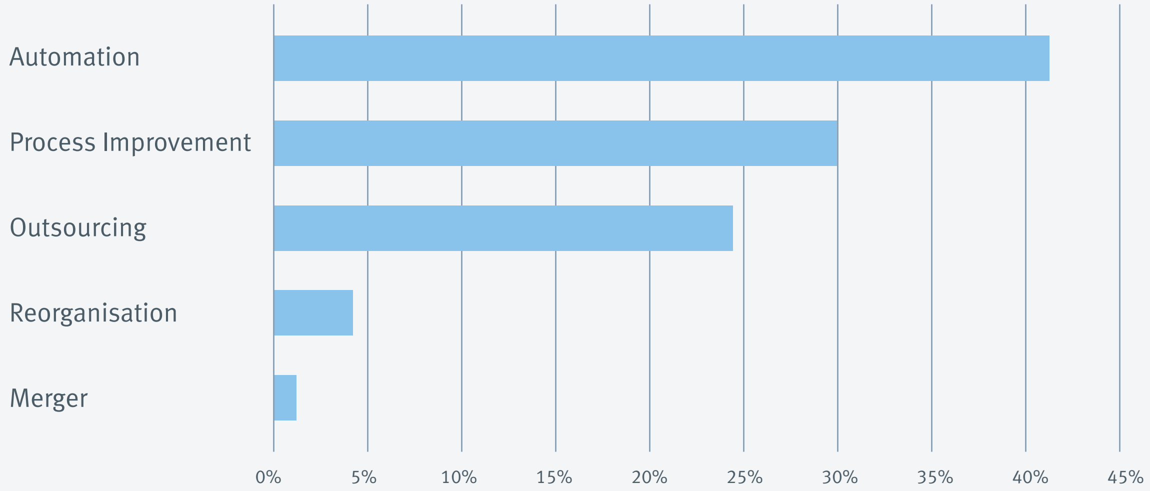

Figure 3: Efficiency options

OPTION 1: AUTOMATION

Automation does not necessarily mean wholesale change to core platform technology. Re-platforming is an increasingly fashionable term but there are no silver bullets and, as technology standards mature, it is increasingly feasible to plug in components to address specific issues.

This option typically makes sense where a high-cost capability is currently manual and costs are proportional to transaction volumes, especially if those volumes are expected to rise.

Transfers are a good example; currently manual and laborious but relatively infrequent. Now however, with the advent of RDR and mandatory in-specie transfers, there is expected to be an explosion in the number of assets transferred onto and between platforms.

With the help of new data standards some software suppliers have already found success in the development of targeted solutions with deployment resulting in impressive efficiencies. One example saw the unit cost of transfers decrease by a factor of five for a platform benefiting from external input.

Similar approaches can be applied to a growing number of platform capabilities, from income drawdown to corporate actions to reconciliations, and we envisage much more of this kind of componentisation of platforms in the coming years.

> One example saw the unit cost of transfers decrease by a factor of five for a platform benefiting from external input.

OPTION 2: PROCESS IMPROVEMENT

Technology is the heart of any platform but how it is used has a big impact on cost. Given that aggregation is the core purpose of a platform, the aim must be to structure processes so that investment activity is standardised.

That means challenging variation, by customer, adviser or even product and getting down to a common core of processing.

Adding a new 3rd Party SIPP to a platform may seem like a quick route to some extra AUA but what if it breaks the current valuation and reconciliation processes?

Issues like this are bigger than any one process and fixing them requires more than the usual process efficiency tools. To make structural improvements it is essential to understand the whole machine and how the parts fit together.

That means viewing platform processes as a series of interlocking pieces – see figure 4 for our view on what this looks like for an intermediary platform.

Combining this view with the cost model allows a platform to better understand the operational impact of 'special' deals but they can't always be avoided. Where variation must be accommodated then platforms need to contain the impact. There are no easy answers but experience has shown some worthwhile options to consider.

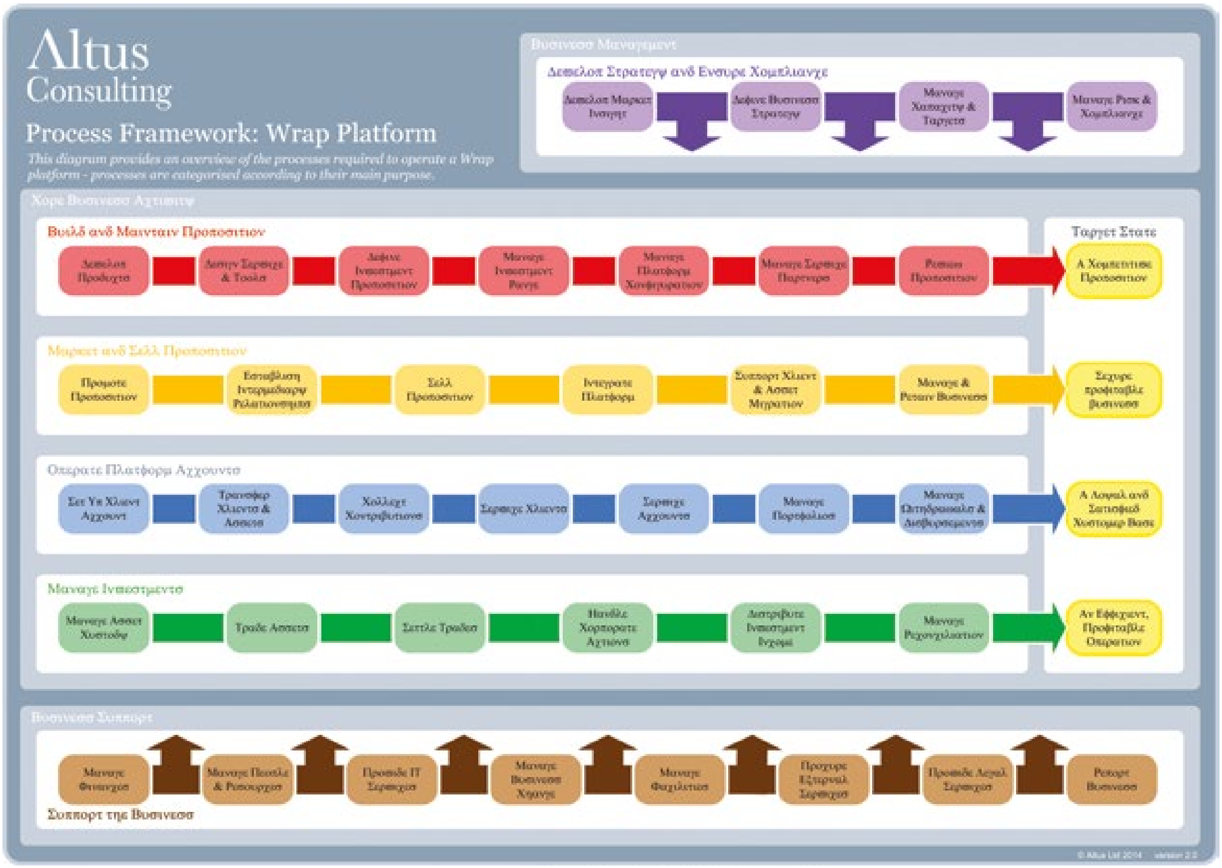

Figure 4: Platform process framework

First, take a step back from how the process works to understand what is being done and why. Begin by modelling the logic of the end-to-end process rather than its physical implementation.

Second, try to consolidate those parts of the process that deal with the variation into one single branch; this will make it easier to manage the work.

Third, make sure that branch occurs as late in the process as possible and that key failure points are tested ahead of it; there's no point doing complex drawdown calculations only to discover the client is ineligible.

Fast Facts

TURNING SCALE INTO ECONOMIES

£49m

The greatest annual loss reported by an adviser platform

£17m

The highest annual profit reported by an adviser platform

OPTION 3: OUTSOURCING

As any industry matures, it is common to see steadily greater use of outsourcing to manage the cost of operations, and platforms are no exception.

Several players already provide asset administration and custody as a core part of their platform service and new entrants are emerging with broader propositions that encompass wrapper and client servicing too.

Some of these have substantial scale and a track record of industrialising operations in asset management that promises to bring much needed efficiencies to the platform industry.

Assuming they succeed, it is hard to see how in-house operations could match their cost ratios and more outsourced deals seem very likely.

Arranging such a deal requires careful planning and management and models of the sort described earlier in this paper can provide a solid bedrock for running the procurement. By understanding the building blocks which make up a business, what they cost and how they fit together, a platform can ensure that the scope of any outsource is right for them and that the costs and benefits genuinely stack up.

Using a model-driven approach to drive the evaluation of alternative suppliers enables everyone to compete on a level playing field and provides a level of objectivity often missing from such exercises.

OPTION 4: REORGANISATION

The final option we must consider is organisational change.

Platforms have grown up rapidly over the last decade and with no established blueprint to follow. As new deals have been struck and new services invented, the shape of each business has adapted to serve these demands.

Now, with greater scale and more established propositions, it is highly likely that the organisational structure of these businesses could be improved.

The best way to do this is to revert to models of the business and the logical services which make it up. Mapping these services to the teams that deliver them will almost certainly throw up some anomalies and highlight duplication of activity across parts of the business.

Redrawing the boundaries of organisational functions to align to activity will almost certainly help to reduce costs.

> Models are the only reliable way to understand costs and to target efficiency gains

> It is important to assess the nature of each cost as well as the scale...

> ...then pick the right options to address the right costs

Conclusion

'Industrialising operations key to regaining profit margins.'

Nobody doubts that platforms are set to dominate the retail investment landscape in the long term. But a combination of competitive pressures, regulatory squeeze and high costs are combining to undermine profitability in the short term. There's little platforms can do about the first two so the spotlight will inevitably fall on costs.

At present there is a disturbing correlation between the growth curve we see in AUA and the costs which the industry accepts as a result of this. The failure to date of the industry to see any real economies of scale paints a worrying picture and one that many investors and analysts would under normal circumstances find alarming. Whilst revenue growth has been impressive for some platforms, the profit lag must be taken seriously.

The highest annual profit reported by an adviser platform in recent times has been just £17m whilst in contrast the greatest annual loss was almost £50m.

Without rapid deployment of new cost-reduction strategies it isclear that this pattern will inevitably have a breaking point - with potentially catastrophic results not just for the platforms and the adviser community but ultimately for the end client whose money is increasingly dependent on the industry's long-term success.

Understanding the complexities of the platform model andidentifying the costs associated with process-rich functionality are essential if the industry is to address the revenue/cost correlation and deliver more acceptable profit margins.

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> ...there is a disturbing correlation between the growth curve we see in AUA and the costs which the industry accepts as a result of this.

The structured method outlined in this paper has already delivered proven results. Five-fold reductions in transfer costs through automation, 45% efficiency improvements in payments processing and the virtual elimination of operations osts from illustrations are all real examples of what this engineered approach can deliver. This is what the industry must embrace to survive.

In short, industrialising operations is the only way to secure the profitable future of what represents the fastest growing and most important part of the UK's investment sector. Tackling the dangerously low profit margins currently being experienced will be the biggest challenge for platforms intent on surviving into the next decade.

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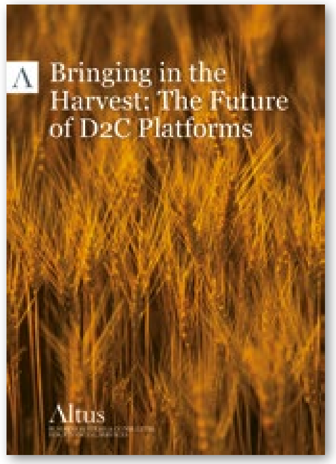

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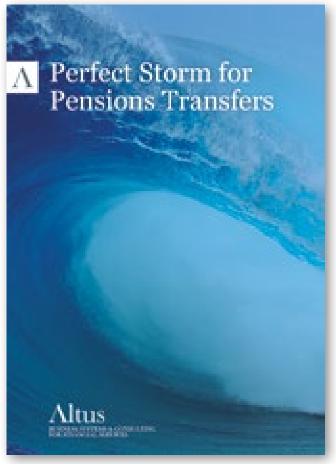

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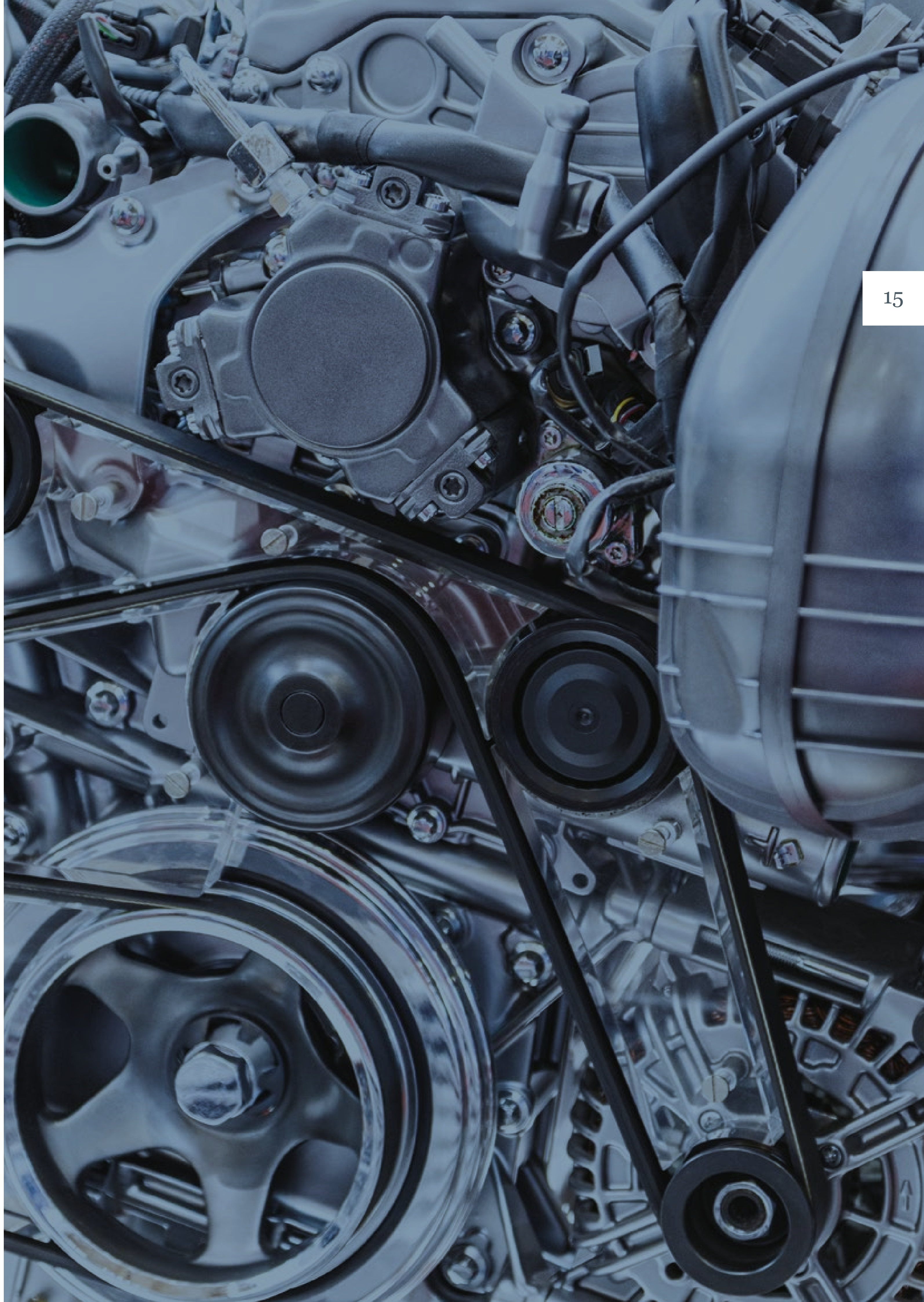

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