



Maximising merger value

When it comes to fund consolidation, whether you are courting or being courted, you need to ensure you get the best outcome for your members, writes [DAVID COOGAN](#), [MARCO FELTRIN](#) and [CATHERINE NANCE](#).

There would be few superannuation fund trustees who haven't considered fund mergers in their business plan. But how do trustees determine which funds to merge with so that they provide the most benefit for their members and how do they realise those benefits?

A merger which merely replicates all aspects of a target fund in a separate division of the merged fund is a merger in name only and is unlikely to provide significant benefits for members. As with the merger of any large entities, it requires much more: the melding of policy and strategy, structure and process, and culture and behaviour.

From a transferee fund perspective, trustees will need to ensure existing members will benefit from any newly merged fund, whereas target fund trustees should consider how to ensure their members receive not just equivalent rights as legally required by successor fund transfer rules, but enhanced benefits.

This is a complex exercise, and our experience enables us to offer some suggestions for managing the process. Excluding legal aspects, we believe there are seven key areas that super funds should

focus on to ensure they derive maximum value during a fund merger:

- Financial due diligence
- Investment due diligence
- Group life insurance arrangements
- Governance and risk management
- Product consolidation
- Tax considerations
- Member Communication

Let's discuss how each of these may contribute towards the successful creation of a merged fund.

However, before any of these steps are addressed, it is important for the trustees and executives of the two funds to perform a high-level assessment of a potential fund merger: the benefits to members of both funds, and any potential implementation issues that could cause the merger to fail.

Such "pre-due diligence" may include:

- Identification of long-term merger benefits (both member and product) through high level understanding of each entity
- Potential for economies of scale in investment management, administration, service delivery and costs
- Agreement on composition, or process to agree composition, of the merged board

- Agreement on process for appointing key executives in the merger entity e.g., agreed CEO or spill of positions
- Branding issues
- Any legal impediments that may exist e.g., in governing rules or trustee company constitutions
- Time period over which due diligence and transition are planned and any exclusivity agreements in dealing with each other over this time

Once the two funds reach agreement that there are potential benefits to both funds and to their members from merging, the key areas listed below should then be addressed.

FINANCIAL DUE DILIGENCE

As with any financial due diligence (FDD), funds considering a merger need to understand the rationale for, and the opportunities and risks associated with, the proposed transaction before determining the scope of the FDD procedures.

In the superannuation industry, the key factors driving merger activity today are likely to include improved operating efficiencies, reduced cost base, and the achievement of scale to drive better net returns for members.

Using those key factors as merger drivers, the FDD scope might include examining the following steps:

Fund income

- Analyse the member profile e.g., active, inactive, lost members and the related fee structures. Understand eligible rollover fund and member benefit protection policies and whether these impact each fund's fee base differently.
- Understand the nature and earnings impact of one-off events (for example, legislative change in 2007 which resulted in large, one-off discretionary contributions) and adjust for these events when assessing potential contribution synergies
- Overlay existing market trends on investment income and assess the impact on the existing and proposed cost bases. For example, lower fees and/or increased management costs arising from: declining asset values and an extended period of low interest rates; a decline in discretionary contributions; and a switch from high risk/higher fee-generating investments to lower risk/lower fee-generating investments.

Cost base

- Understand the investment management relationship, including the basis for remunerating investment managers (management fee percentage, performance fee hurdles)
 - Analyse the fixed and variable cost base, by identifying and understanding what cost synergies may be generated post-merger; for example, one asset consultant, one custodian, one set of financial statements, larger fund manager balances, etc
 - Analyse the historical financial ratios, understand what is driving change in the ratios, and compare them to the existing ratios
 - Identify and quantify potential opportunities and risks relating to the future cost base (e.g., adverse legislative change regarding fees; fewer secretariat, audit and APRA fees; reduced legal and trustee costs).
- Given that achieving efficiencies is likely to be a key reason for the merger, it is important that potential synergies and cost base adjustments are identified and reflected correctly in the merger valuation model.

Reserves

- Understand what reserves exist and fund reserving policies. If these vary greatly e.g., one fund has significant reserves

build up compared to the other, then equity issues may exist on merger.

- Understand how reserves move. Are there any differences in fee structures including tax treatment that would be aligned on merger and result in unexpected reserve movements?

Unrecorded liabilities

- Understand key supplier and employment contracts and whether any liabilities would be triggered in the event of a merger
- Consider any unresolved audit or regulator issues which may give rise to a liability such as a unit pricing error
- Understand trustee insurance arrangements including potential run off insurance.

INVESTMENT DUE DILIGENCE

In undertaking due diligence on a target fund's investments, two broad areas require consideration:

- Investment strategy (comparing the asset allocation structures of the target fund's investment options)
- Implementation (analysing the underlying investments for any material issues).

Investment strategy: Will new investment options be needed?

The investment options of both funds should be compared to identify any material differences between their asset allocation structures. If there are material differences, a decision will need to be made on how best to manage them (e.g., whether new investment options will need to be created to accommodate the target fund).

The investment strategies of each fund's default option will probably be of the greatest importance, as they are likely to affect the majority of members.

Implementation: Have all the possible issues been identified?

Due to the complexity of many investments, a number of implementation issues will need to be managed. For example:

- Understanding the structure of the underlying investments (particularly for synthetic investments)
- Transferability/liquidity of assets – many alternative assets have lock-in periods and may not be easily sold or transferred
- Valuation of assets – to ensure equity among members of both funds, asset valuations must be up to date and accurate
- Committed capital/additional liabilities – does the target fund have any uncalled

capital commitments or potential liabilities in respect of the assets to be transferred?

In addition to controlling costs, an efficient implementation is expected to effectively manage out-of-market risks (the risk of assets not being fully invested during a time when markets rise) and market impact (the impact that trading securities could have on the market price of securities). It is worth considering appointing a specialist transition manager to assist with transferring assets if there is insufficient in-house expertise for this.

From an investment perspective, success will depend on the timeliness and cost of the transition and whether any additional savings can be generated as a result of greater economies of scale.

GROUP LIFE INSURANCE ARRANGEMENTS

There are broadly four questions that need to be answered with regard to insurance benefits:

- What are the current insurance benefits and premiums of the target fund?
- What will be the insurance benefits and premiums for the merged fund?
- Who will be the insurer for the merged fund?
- What will the member takeover terms be?

Current benefits vs merged fund benefits

The insurance benefits of the target fund need to be compared to those of your fund, to determine:

- What the insurance benefit design and premiums will be following the merger
- How those who are members of both funds simultaneously will be affected by any changes in cover, premiums or terms and conditions (such as the definition of disability). Are there any specific member categories that could be disadvantaged?
- Any specific issues that need to be addressed, such as self-insured benefits.

The merged fund's insurer

Assessing the benefits issues listed above will help in determining who will be the ongoing insurer for the merged fund.

Member takeover terms

This refers to how members of both funds will transition to the new, merged fund. The following issues and risks need to be considered:

- The automatic takeover conditions: To ensure that members' insurance arrangements are not adversely affected by the merger.
- The default options on transfer: Any

changes to covers or premiums need to be carefully communicated to members.

- Other possible transfer options: What, if any, options will be provided for existing and transferring members (such as a continuation option for members who do not transfer)?
- Unresolved death or disability claims: The ongoing administration, including those claims not yet reported.
- Clarity of responsibility: It is essential to have absolute clarity, for all members and under all circumstances, as to when the incoming and outgoing insurers are on or off-risk.

Success could be measured in two ways: by increases in insurance covers and any improvements in premiums or terms and conditions resulting from the larger membership base; and by the smooth transition in relation to cover from transfer date onwards and claims management from the previous fund.

GOVERNANCE AND RISK MANAGEMENT

Risk management is a vital aspect of operations, and as part of the due diligence process, each fund will want to understand how risk has been managed prior to integration to give comfort that there are no skeletons in the closet. Areas of interest would include:

- History of compliance breaches and whether they indicate systemic issues
- Any unresolved regulator investigations
- Any unit pricing or crediting rate errors
- Any known frauds and, more broadly, fraud control plans
- Any pending litigation
- Any adverse audit findings

Risk management needs to remain intact during the integration process.

Here are some suggestions for questions that a risk and audit committee could ask as part of obtaining assurance that risk management is intact during the integration process.

- Has a risk management function been set up (and adequately resourced) to meet the new entity's risk management needs during the transition phase and beyond?
- Has a consolidated risk management framework been prepared, together with appropriate governance and risk reporting protocols?
- Has a consolidated risk profile been prepared? Are there any systemic misalignments that require immediate attention?
- Does the risk and audit committee, as well as senior management, have a grasp of the key risks facing the combined entity in the short and long term?

- Are strategies in place to resource and manage risks in a reasonable timeframe and is there a solid connection to the assurance program?

All of the above constitutes a basic checklist which will allow an organisation to test whether requisite standards of risk management continue to be met during – and following – the merger transition phase.

PRODUCT CONSOLIDATION

Data conversion and migration can be a major source of risk for superannuation organisations – whether they are undergoing fund mergers, change of administrators, product acquisitions, system upgrades or platform consolidations.

The introduction of errors during a conversion or migration can result in significant rework and remediation down the track that may in some cases totally erode any business benefits from the project.

Here are some key success factors that have helped some of our clients manage this challenge:

- **Plan, manage and monitor carefully** – Data conversions are usually complex, broad-reaching and data-intensive. The use of structured project management and project management office techniques will facilitate a seamless process.
- **This is a business issue** – Many product consolidations or system changes are IT-led initiatives. But it is the business that truly understands data and product feature criticality, and therefore it is the business that is ideally positioned to control the process.
- **Get data quality right first** – Data quality is an issue for many legacy products. Rather than transferring the problem, or complicating the migration process, a data clean-up should be undertaken in advance of the move, and should take into account the target system requirements.
- **Start with a clean slate** – The world doesn't stop for data conversions. Depending on the size of the product or fund, the conversion window could span a few days. To avoid reconciliation and unit pricing nightmares down the track, simple controls over cash and asset movements (applications, redemptions, corporate actions etc) will help ensure there are no major non-timing-related variances that might affect the conversion.
- **Adopt a risk-based approach to control** – Controls must be designed to cover the completeness, accuracy, security, confidentiality and usability of the data

that is migrated. But that doesn't mean that everything has to be controlled to the 'nth degree'. A focused and more effective control program can be established by assessing the criticality of data and the risk of error.

- **Practice makes perfect** – Before transferring and consolidating data in new systems, practice the full end-to-end process as many times as the time-frame allows. This includes ensuring the business is aware of what to do to manage business-as-usual and other priorities, immediately before, during and after conversion.

Focusing on these success factors from the outset will contribute towards a more successful conversion or migration of data and will help to ensure overall project benefits are still delivered.

TAX CONSIDERATIONS

Rollover relief

Until the recent introduction of rollover relief, the fund that transferred all its assets to the successor fund realised all its unrealised gains and losses for income tax purposes.

Where the net result was a realised capital gain, the transferring fund crystallised a tax liability earlier than would have been the case otherwise. While paying tax earlier is not ideal, it is merely a timing difference which had no impact on members' account balances. The only negative impact for the members was the lost earnings on the cash that was used to pay the tax early.

Where the net result was a realised capital loss, the transferring fund would not have been able to utilise that loss, therefore losing the tax benefit attributable to it. This had a direct impact on the members' account balances and, given the state of the existing market, was the reason many likely mergers did not proceed.

In response to this problem, the Government announced CGT rollover relief with effect from 24 December 2008. However, Treasury's proposed rules highlighted significant impediments, and an expansion to the proposed rules was announced on 29 April 2009.

The expanded proposal should now enable super funds to merge with greater ease.

The rollover relief will be extended to 30 June 2011 (previously 30 June 2010), allowing extra time for funds that have not yet started the discussion about merging. Any further extension or any permanent relief will need to be recommended by the Henry Tax Review.

The rollover relief will also apply to

mergers involving PSTs and the complying superannuation business of life insurance companies.

Funds in a net unrealised capital loss position will be able to roll over assets with both capital gains and capital losses, rather than just assets with capital losses.

Previously realised net capital losses and revenue losses can also be transferred to the successor fund.

Although it was not mentioned in the recent press release, we understand that no adjustments are likely to be required to the cost base of assets, due to the exempt pension income.

Stamp duty

Stamp duty is likely to apply on the transfer of many of the assets in a merger, but a number of conditional exemptions are available. Accordingly, stamp duty exposures need to be carefully considered and managed. This is even more important as stamp duty is a state-based tax and is therefore complex (each state has slightly different rules and exemptions).

The major challenge is obtaining the relevant information for each investment, especially where assets are held indirectly through unit trusts operated by third-party fund managers.

Deferred tax assets

An important consideration – given the current environment – is the level of deferred tax assets that each fund is carrying in its balance sheet and in its crediting rate or unit price. For example, if one fund has a deferred tax asset of 2 per cent of net assets and the other fund has 4 per cent, the fund with the smaller amount may have difficulty accepting the merger. It is also important to understand if trustees take a different view on the level of DTAs in the balance sheet as opposed to the unit price or crediting rate.

MEMBER COMMUNICATION

Assuming a planned merger progresses to the next stage, a number of stakeholder communication issues will need to be addressed. These include communications to members, service providers, regulators and employers. This aspect needs to be very carefully managed, and in our experience leadership from the CEOs and chairs of each board can have a very positive impact on the final outcome.

MEASURING SUCCESS

Finally, once the merger has taken place, there will need to be a monitoring process to compare the benefits that have been

MERGER CHECKLIST

High-level review	What are the short and medium-term benefits to members and products? Are there economies of scale in investment management? Are there economies of scale in administration, service delivery and costs? What are the costs/benefits of improved benefit options? Will a merged board and secretariat better manage governance and oversight? Where should any savings be invested?
1. Investment due diligence	Are there material differences between the asset allocation structures of the two funds' investment options? Have all the possible implementation issues (e.g., transferability of assets, valuation of assets, uncalled capital commitments) been considered?
2. Group life insurance	How do the target fund's insurance benefits compare to those of your fund? Who will be the insurer for the merged fund? What will the member takeover terms be?
3. Financial due diligence	What are the key drivers for the potential merger? Has investment and contribution income been analysed for trends and the impacts of those trends? Has the cost base been analysed for potential synergies and adjustments?
4. Governance and risk management	How will governance and risk management be addressed in the merged entity? (eg function, risk management framework, protocols, consolidated risk profile) Are the risk committee and senior management aware of the key risks facing the merged entity? Are strategies in place to resource and manage risks?
5. Product consolidation	Is management addressing the six key factors that will influence the success or otherwise of the data conversion and migration program?
6. Tax considerations	Has all the information relevant to stamp duty been obtained for each investment (including assets held indirectly through unit trusts operated by third parties)? Do the two funds have different levels of deferred tax assets? If so, have the implications of this been considered?
7. Final matters	Has a dedicated oversight body (such as a board subcommittee) been established to consider the findings of the discovery process? Have key practical matters such as contracts, levels and types of reserves, defined benefit categories, distinguishing features, etc been considered? How will information be communicated to stakeholders? How will success be measured?

achieved with those that were expected. This process needs to be very diligently followed in the months succeeding the merger to ensure any post merger issues are managed in order to deliver the benefits expected.

In our experience, a successful fund merger is one that has been well planned and executed. Execution is of utmost importance

and the 'transition Board' of post merger Board and executive management need to be adequately resourced to achieve the outcomes expected. **SF**

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