

MS17/1.2: Annex 4

Market Study

Investment Platforms Market Study

Interim Report: Annex 4 – Financial Analysis

July 2018

Annex 4: Financial analysis of firms competing in the investment platforms market

Introduction: why we performed a financial analysis

1. We performed a financial analysis of firms competing in the investment platforms market for two main reasons. First, we wanted to understand the financial incentives of platform firms operating in the UK market through analysing their business model and how they generate profits. We looked at revenues, expenses and operating profits across firms. We examined how these key performance indicators are affected by size and maturity of firms, vertical integration, as well as the consumer segment served (Direct to Consumer ('D2C') vs adviser segments). We also looked at how these indicators have changed over time.
2. Second, we wanted to understand what financial performance suggests about how competition is working in the platforms market. Firms in a competitive market would generally earn no more than a "normal" rate of profit although, in the short term, profitability could be higher or lower than the normal rate. As a result, the financial performance of firms representing a substantial part of the market can be a useful indicator of competitive conditions in this industry.
3. This annex summarises the following topics:
 - **Methodology and data:** we provide an overview of the scope of our sample. We also discuss some issues related to the data we received and its limitations.
 - **Revenues:** we provide a detailed overview of the various sources of revenues for firms in this market, and how these vary across our sample.
 - **Operating expenses:** we review the largest components of firms' cost base, and quantify the total cost base for each firm.
 - **Financial performance:** we analyse how financial performance varies across our sample. We also carry out 3 different segmental analyses: variation of operating profit by size and maturity of firms, by group strategy (stand-alone platforms vs firms part of vertically integrated groups) and by the segment served (D2C vs adviser segments).

Methodology and data

4. We carried out an in-depth financial analysis of 20 of the largest firms based on AUA. These players together have approximately a 90% market share, based on AUA. They are also representative of the various business models in this industry. Our sample focused on platform service providers, as per the FCA definition and did not incorporate any comparable firms. Overall, our work focuses on the analysis of revenues, operating expenses, and ultimately operating profit.

5. Our sample included 5 stand-alone players and 15 platforms that are part of a vertically integrated group. There were 6 firms in the D2C segment, 10 firms in the adviser segment and 4 firms in both. There were a number of established, large players and also some newer entrants. Half of the firms in our sample are less than 15 years of age. We collected data at firm level, and also at platform level for revenues and some key metrics.
6. We collected annual financial data over almost a 5-year time horizon, starting in 2013 and covering the last available period for 2017.¹ At the outset of the project we wanted our analysis to cover a full economic cycle, but changes in policy and ultimately reporting systems imposed by RDR represented a challenge for firms. As a result, we decided to start our data set in 2013. This time series gives us a reasonable basis to reach robust conclusions.
7. We experienced some limitations which impacted our analysis. Most significantly, challenges around data availability restricted our ability to make adjustments to accounting operating profit. For instance, it could have been informative to re-value proprietary technology assets using the Modern Equivalent Asset method², instead of relying on their accounting value. But in the absence of consistent data on capital employed, we have no basis to do so. However the impact of such adjustments is likely to be limited, given the asset light nature of this industry (see paragraph 12). Our methodology still conveys a representative picture of the financial performance of firms in this market.
8. We note that the sample does not encompass the whole market and that the limited number of data points (limited sample of firms and limited time period) make some analysis more challenging. This is particularly relevant when sub-dividing our sample of firms by various categories thereby reducing the sample sizes. Overall, we are confident in the inferences presented in this document, even if they might not be statistically significant.

Impact of vertical integration on the financial data we could collect

9. Three quarters of platforms in our sample are part of a vertically integrated group. This means that the majority of our sample does not consider the platform unit as a stand-alone business, but as a constituent of a wider value chain alongside asset management and advice. This has two important implications for our work, on cost and capital allocation.
10. First, the cost allocation methodologies used by vertically integrated platforms are embedded in the data we collected. Our analysis relies on firms' own methodology for a large portion of our sample. While we are confident that reported figures are consistent with firms' management accounts, we recognise there are likely differences across the sample. To make the data consistent, we adjusted revenues data from firms in order to differentiate revenues streams attributable to the platform business (see paragraph 21 and figure 4.1 for further details).
11. However similar restatements on the cost side were not possible given the lack of granular data. For instance, the challenges of allocating costs for vertically integrated firms are relevant for marketing expenses. While the customer acquisition strategy underpins the whole investment and advice value chain, marketing cost can be allocated at the platform level or apportioned along the value chain. As a result, some

¹ Firms were able to report 2017 data for varying time periods (most commonly for 6 months)

² It would have been most appropriate for firms adopting a clear and differentiated strategy of proprietary technology

costs for vertically integrated firms might be inflated or understated, compared to stand-alone players. This challenge is exacerbated when firms rely on cross-selling beyond the perimeter of the platform activity to achieve their strategic objectives³. For example, a vertically-integrated firm may not be in a position to quantify the extent to which their marketing budget has benefited to the wider brand.

12. Second, most firms did not return granular information about the capital supporting their platform business. Across our sample, only a limited number of firms provided us with a balance sheet that solely related to the platform activity. A set of firms gave us details on their balance sheet but for a larger perimeter than the platform entity⁴ (typically including the asset management and/or the advice businesses). As a result, our assessment of financial performance is based on operating profits and does not encompass the economic cost of capital. That being said, evidence suggests a moderate economic cost of capital for the platform industry. Investment platform businesses are relatively asset-light, similar to other businesses in the investment space. Across our sample, depreciation and amortisation expenses only represent 5% of the cost base, on average (2016). When asked whether any regulations have limited their ability to compete with other platforms none of the firms flagged regulatory capital as a source of concern. This substantiates our view of a relatively moderate amount of capital required by platforms.
13. Overall, we are confident that we can reach robust conclusions on firms' incentives using revenue analysis and operating profit margin. More generally, we believe that the metrics used in this study allow us to have a fair assessment of firms' performance. They also provide useful indication of competitive conditions in the investment platform market.

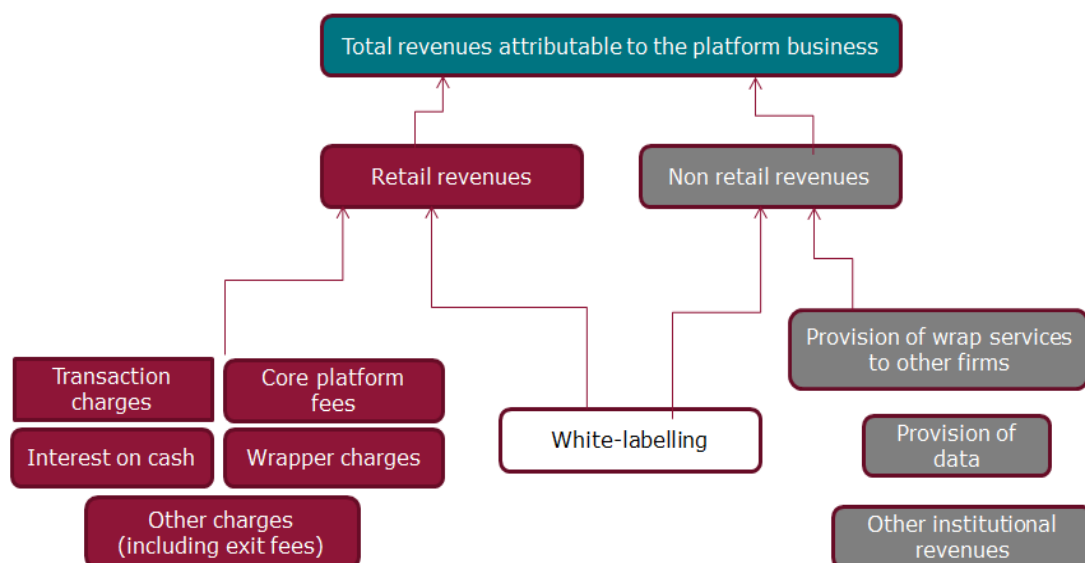
³ We note that approximately half of the firms (11 firms in our sample) stated in response to our request for information that cross selling their platform offering with either asset management or advice services is core to their strategy.

⁴ A firm reporting its platform activity across several legal structures was a common challenge to comply with our request. For instance, one firm noted that its prudential capital is not allocated on a platform/non-platform basis. Another firm flagged that its platform activity is booked into 3 different regulated entities, hence arguing that all of the 3 entities' prudential capital is required by the platform activity.

Analysis of platform revenue

14. Post the Retail Distribution Review (RDR), platforms have generated revenues primarily from retail consumers and to a much lesser extent from corporate customers and activities. We have analysed firm revenues to understand more about how firms behave. In this section we outline our analysis of:
 - platform revenue growth
 - variations in revenue sources
 - other revenue sources
 - retail prices
15. In order to aid comparability over time and across firms we made a number of adjustments and allocations in our revenue analysis:
 - Revenues from advice or asset management products have been stripped out of platform revenue for this part of our analysis.
 - We have treated fund manager rebates from earlier years as consumer revenue to enable comparability over time. As expected, post RDR commission from fund managers had fallen substantially in the years to 2016 and all platforms reported no revenue from rebates in 2017.⁵
 - We have considered retained interest on client cash as retail revenue. It is equivalent to a charge as it relates to forgone interest by consumers.
 - A few firms reported some corporate revenue sources such as the provision of custody or other services for in-house funds and the provision of wrapper or stockbroking services to external companies. Where identifiable, we have reclassified revenue sharing from white labelling agreements as retail revenue.⁶ The remaining proportion of commercial revenue streams appears to be falling and represented less than 4% of platform revenues in 2016.
16. The figure below illustrates the key revenue categorisations used.

Figure 4.1: Key revenue categorisations



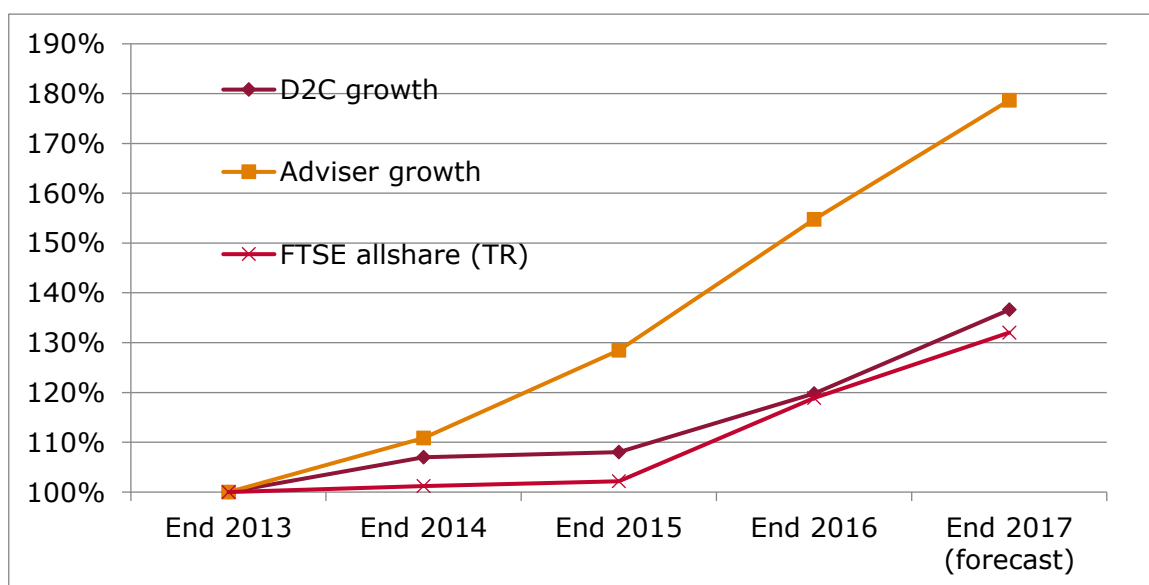
⁵ Most firms supplied figures for H1 2017 only

⁶ Unless it has been excluded from the AUA figures or would lead to double counting in which case we have excluded it entirely. So, revenue from white labelling is in some cases treated as retail revenue, corporate revenue or excluded on a case by case basis.

Platform revenue growth

17. Our revenue analysis was intended to explore firm incentives and how they may have changed through time. We briefly recap on some headline market dynamics and the economic backdrop over our analysis period.
18. As illustrated in the figures below revenue growth over our analysis period has been strong for both D2C and adviser platforms. Based on our data we estimate⁷ that platform market revenue growth for the 4 years to December 2017 will be 60% or 13% per annum.
19. A number of factors explain platforms' revenue growth. Market conditions have been favourable for revenue growth in the platform market over our analysis period. Ad valorem charging at the majority of firms means that rising markets result in greater firm revenues. The legislative environment is also likely to have been beneficial to the platform market.
20. As we observe firm revenues growing quicker than the UK equity market⁸, this implies that some revenue growth is attributable to firms attracting new money to the platform or from external acquisitions. The Government-introduced pension freedoms will have contributed to asset growth on platforms from April 2015.

Figure 4.2 – Revenue growth for D2C and adviser platforms and the UK equity market, 2014-2017

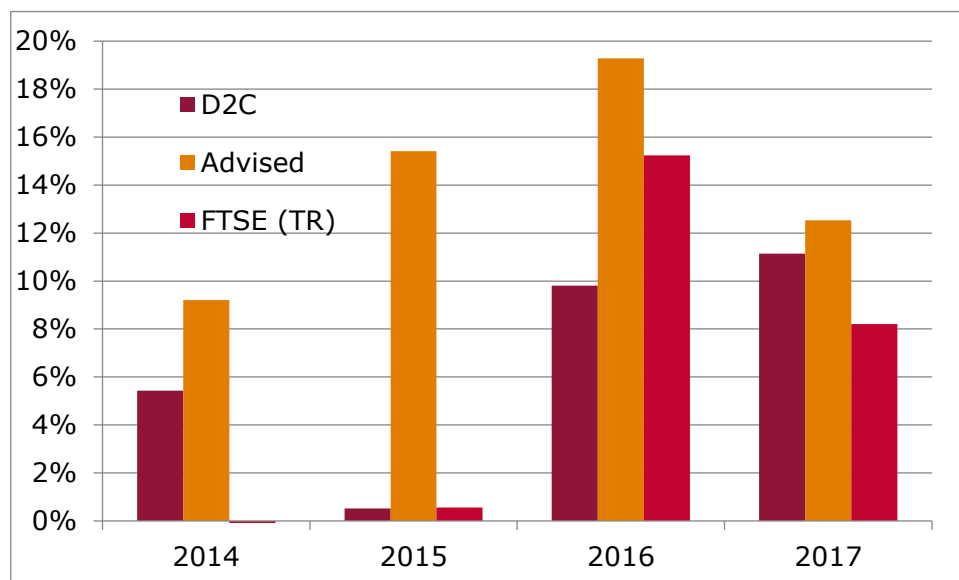


Source: FCA

⁷ Firm figures for 2017 are generally based on revenue to 30th June and have been annualised.

⁸ Our figures suggest that 89% of investor assets are invested in equities or funds as at 30th June 2017.

Figure 4.3 – Year on year revenue growth for platforms and the return on the UK equity market in real terms⁹, 2014-2017.



Source: FCA

21. The figure above illustrates year on year revenue growth for D2C and adviser platforms in real terms. It shows that the adviser platform sector grew revenue particularly strongly in 2015 despite lacklustre equity markets and D2C growth that year. Generally it can be seen that the growth in revenue for adviser platforms has consistently outpaced the D2C market year on year but that it is expected to be of a similar magnitude in 2017.

Variation in revenue sources

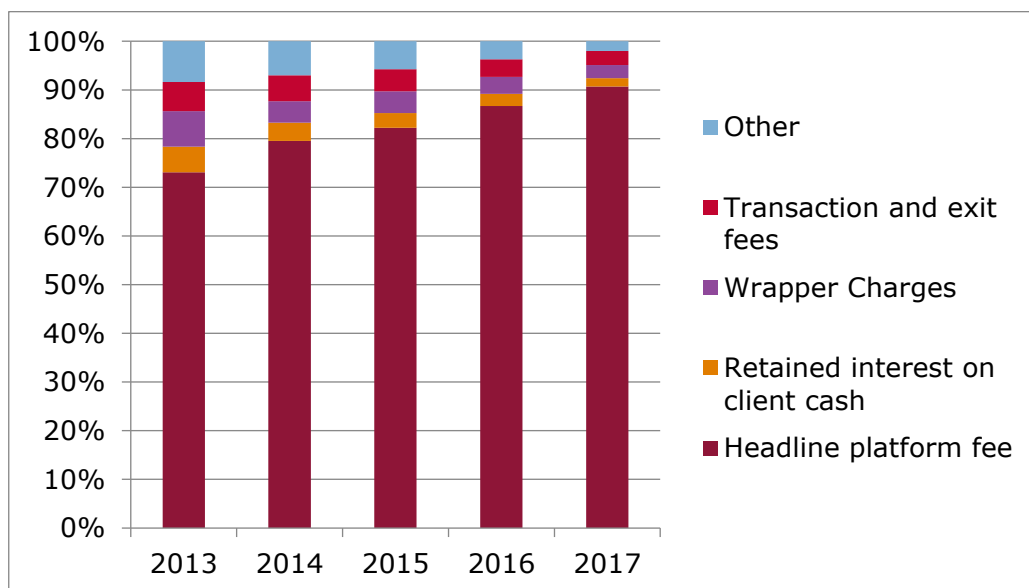
22. The revenue figures reveal a variety of pricing structures and terminology of charges. For example, several platforms reported zero revenue from headline platform fees in favour of categorising revenue as wrapper charges whereas others reported just headline platform fees and some reported both platform and wrapper charges. In the figures below we reclassified wrap fees as headline platform fees for 5e firms¹⁰ in order to generate a more comparable picture.
23. As illustrated in figure 4.4, adviser platforms generate an increasing proportion of revenue from headline platform fees¹¹. In 2017, 91% of adviser platform revenue was generated from headline platform fees. However, there are significant variations at firm level, for example one firm reported 24% of its revenue for the first half of 2017 came from retained interest on client cash.

⁹ We have calculated real returns as those in excess of CPI

¹⁰ In several cases there were no reported headline fees and the wrapper charges varied by wrapper type. In these cases all wrapper revenue was classed as headline platform fee despite that some may consider the GIA 'wrap fee' rate as the headline platform fee and the difference a supplementary wrap charge. Consequently, the proportions from wrapper charges should be deemed an indicative minimum.

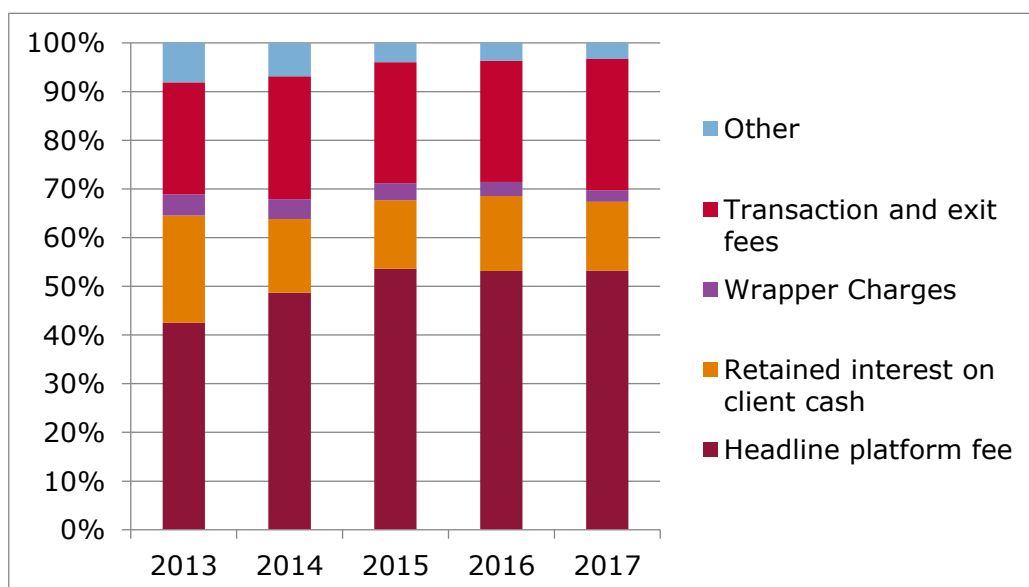
¹¹ Headline platform fees from consumers include fund manager commission payments to the platform. For platforms reporting zero headline fees wrapper fees have been substituted.

Figure 4.4 - Adviser Platform Revenue Breakdown



Source: FCA

Figure 4.5 – D2C Platform Revenue Breakdown



Source: FCA

24. The proportion of D2C platform revenue from headline platform fees has also increased slightly but is significantly below that of adviser platforms. In 2017, just 53% of D2C platform revenue was generated from headline platform fees. As for the adviser platforms there is a wide divergence in underlying firm revenue structures, for example the amounts from transaction and exit fees for 2017 ranged between 0% and 59% across different D2C platforms.
25. We observe that fees appear, from a revenue perspective, to be simpler for adviser platforms compared to D2C because a greater proportion comes from headline fees.

As illustrated above, platforms generate revenue from retail consumers in a variety of ways.

26. We considered if particular revenue structures and streams could lead to a competitive advantage. However, we found firms were just as likely to be profitable or to experience high levels of growth where they derive most of their revenue from headline fees as where firms derive their revenue from a wider range of sources.

Other retail charges: Interest on cash, transaction charges, wrapper and exit fees

Interest on Cash

27. Platforms generate significant revenue from interest on client cash holdings. The revenue generated is substantially higher for D2C compared to adviser platforms (see figures 4.4 and 4.5 above). There are several factors which influence the levels of this revenue stream; the sizes of cash balances¹² the pricing/charging structure of the firms, the prevailing interest rates and the extent to which firms negotiate higher rates from banks. Platform firms may be able to secure better rates of interest than individual consumers would be able to obtain directly from banks, either by pooling client cash or by other permitted business practices¹³. Where this benefit is passed onto consumers by way of reduced headline platform fees or via interest paid, this could be positive for end consumers.
28. The overall proportion of industry retail revenue sourced in this way has fallen over our review period. This may have been driven by the fall in base rates¹⁴ and bank appetite for platform business¹⁵ rather than platform behaviour.
29. Of the firms that do make revenue from retained interest on cash the average proportion was reasonably stable over our review period between 11 and 14%. However, we noticed pronounced differences at firm level with a range of zero to 56%.¹⁶ We also noticed that some firms retain and/or pay different interest rates depending on the wrapper or account type.
30. We found that some firms have stated policies on retained interest which allow them the flexibility not to pass on increases in interest rates to consumers. For example, a firm which states it pays base rate less 0.75% has significant potential to earn more revenue if base rates do increase from the current level of 0.5%. Given that interest rates were low over our review period and have begun to increase, it seems probable that the amounts of revenue firms make from cash holdings will increase from 2016 levels.
31. Figures 4.4 and 4.5 above show that the adviser platforms make significantly less revenue from interest on client cash than D2C platforms. Cash is more than double

¹² We recognise that interest rates are currently at a low level and that cash balances in low return accounts reduces as interest rates rise, consequently we recognise that the size of the cash balances within total AUA may reduce if base rates rise. .

¹³ In so far as is compliant with our regulations and other legal requirements. For example, some client cash can be put on longer term deposit and can therefore attract a higher rate of interest.

¹⁴ Base rates were at historical lows over our analysis period: 0.5% until August 2016 when they fell to 0.25%. Current rates have returned to 0.5%.

¹⁵ CP17-29 (www.fca.org.uk/publication/consultation/cp17-29.pdf) discusses how some investment firms have experienced difficulty depositing client money with banks in accordance with CASS requirements. Policy statement PS18-02 will mitigate the issue for some platforms to the extent that they are subject to our client money rules, see www.fca.org.uk/publication/policy/ps18-02.pdf.

¹⁶ Across all platforms for all years

the proportion of assets on D2C compared to adviser platforms (9% compared to 4%) so this accounts for the majority of the difference in revenue.

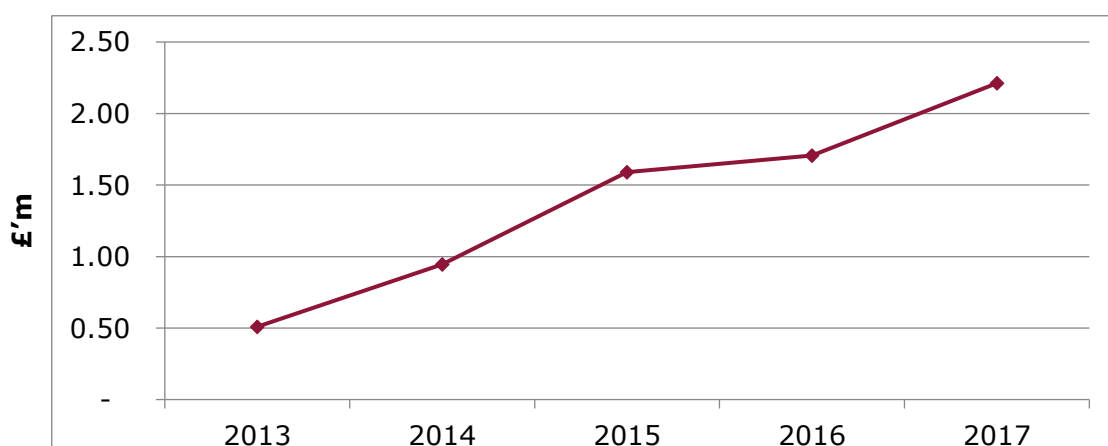
Transaction charges

32. We found significant revenue generated from transaction charges for both D2C and adviser platforms. Where firms did not provide a breakdown of the types of transaction fees we applied the AUA split of assets for the firm in order to apportion. Most frequently transaction charges relate to stocks and shares, but also they also relate to fund trading charges levied by platforms¹⁷ and to other charges.
33. As illustrated in figures 4.4 and 4.5 above, the proportion of revenue generated from transaction and exit fees is higher for D2C than for adviser platforms. Much of this discrepancy is because D2C consumers hold and transact more direct equities than advised consumers (see annex 1 – market overview).

Exit fees

34. Although the proportion of platform revenue derived from exit fees has risen both in absolute terms (see figure 4.6 below) and in relative terms from 0.06% to 0.17% over our analysis period, it remains small. The largest contribution to revenue across our sample was 1.4% of revenue at any one firm. To the extent detriment arises from exit fees, it is likely underestimated by any revenue analysis. Any quantification does not capture where the existence of exit fees has reduced exits. The wider impact of exit fees on effective competition is discussed in chapters 3 and 8.

Figure 4.6 - Exit fees (£'m)



Source: FCA

Retail prices

35. In order to inform our analysis of price competition in the platform market we constructed a retail 'price proxy' for platforms. We did this by dividing each platform's revenue from retail consumers by average AUA¹⁸ for the year. This figure is preferable

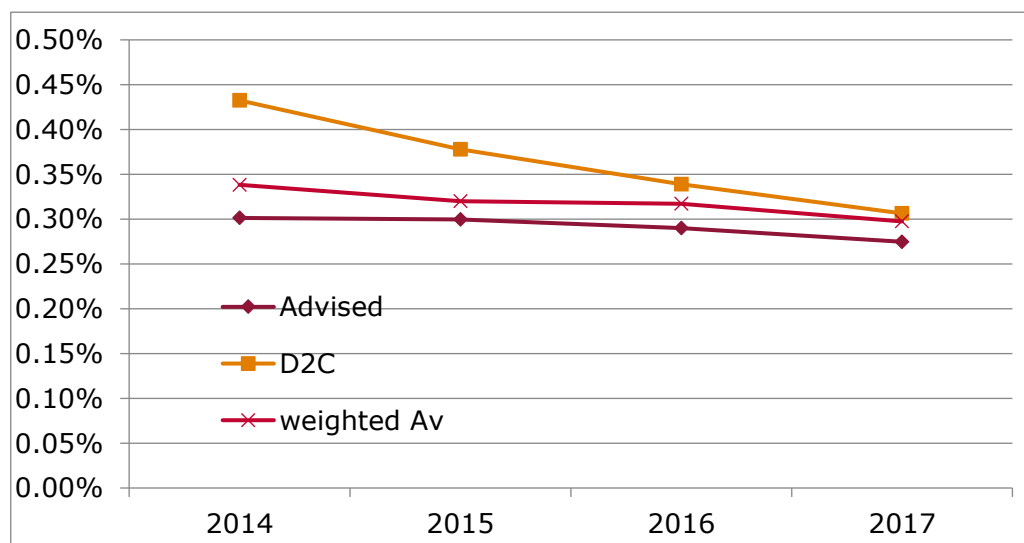
¹⁷ These are charges some platforms charge customers for buying and selling funds, not to be confused with trading charges within funds which are paid for indirectly through fund assets and do not contribute to platform revenue.

¹⁸ Simple average = (AUA year end + AUA previous year end)/2

to headline figures as it includes all charges paid by the platform consumers inclusive of headline platform fees¹⁹, wrapper charges, transaction fees, retained interest on cash and other miscellaneous charges.²⁰ As it is an average it does not reflect the range of prices paid by different consumers and could also be distorted by any significant changes in AUA throughout each year.

36. The averages²¹ for the D2C and advised segments along with the combined AUA weighted average are shown in the figure below. The figures indicate a fall in the average fees paid by consumers in both platform segments over the 4 year period.

Figure 4.7 – Price proxy Adviser²² platforms compared to D2C²³



Source: FCA

37. Comparing the average price proxy figures for different platform types suggests adviser platform revenue margins have fallen less than D2C platform revenue margins. The two segments appear to have converged to a similar average revenue per consumer AUA of 0.27% and 0.30%.
38. As illustrated in figure 4.8 below the trend in retail revenues per customer shows a more mixed result. The weighted average retail revenue per customer has remained relatively flat over our time period and has increased quite substantially for adviser platform consumers. One significant factor likely to be driving this difference in trend is that platform AUA has grown at a faster rate than customer numbers (24% compared to 18% CAGR over 2013-16). In a market with a significant proportion of ad valorem based fees it is to be expected that revenues will increase in absolute terms as AUA rises.

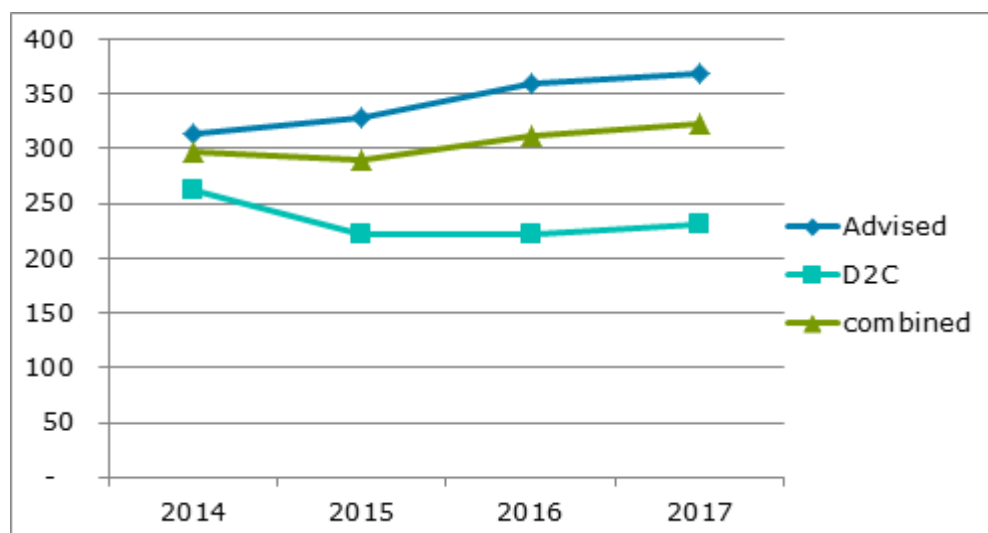
¹⁹ For earlier years we included fund manager commission rebates as retail revenue to ensure comparability across years and firms.

²⁰ This calculation only includes fees and charges levied by the platform for its services and therefore does not include other charges payable across the value chain such as advice or fund management fees (fund charges).

²¹ Simple average = $\sum \text{price proxy for each platform} / \text{number of platforms}$. Based on 25 platforms (15 advised and 10 D2C)

²² Based on 15 platforms

²³ Based on 9/10 platforms

Figure 4.8 – Retail revenue per customer, expressed in £ per customer

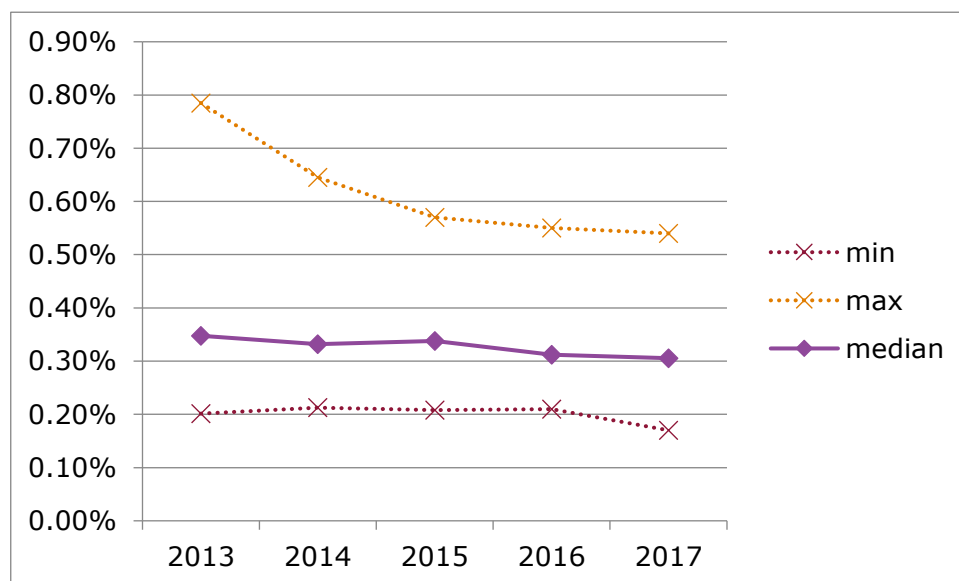
Source: FCA

Revenue per customer, self-reported by firms

39. We asked firms to supply average fees paid by their customers from 2013. For firms who excluded trading costs we adjusted the figures as per the ratio stated in the firm's revenue breakdown. Of the firms that responded in a useable format, customers on 4²⁴ of the platforms will have experienced increasing prices and 12²⁵ decreasing prices. The simple average of the responses suggests a fall from 37 bps to 31 bps. As illustrated by the figure below the maximum amounts paid across our universe appear to have fallen substantially from 2013 to 2017 by 25 bps or almost one third.
40. The self-reported figures support the indications from our analysis of revenue/AUA, that prices measured on this basis have been falling in this market, more so for D2C than adviser platforms.

²⁴ On 3 adviser platforms and 1 D2C²⁵ On 8 adviser platforms and 4 D2C

Figure 4.9 – Ranges of self-reported average fees paid by consumers²⁶



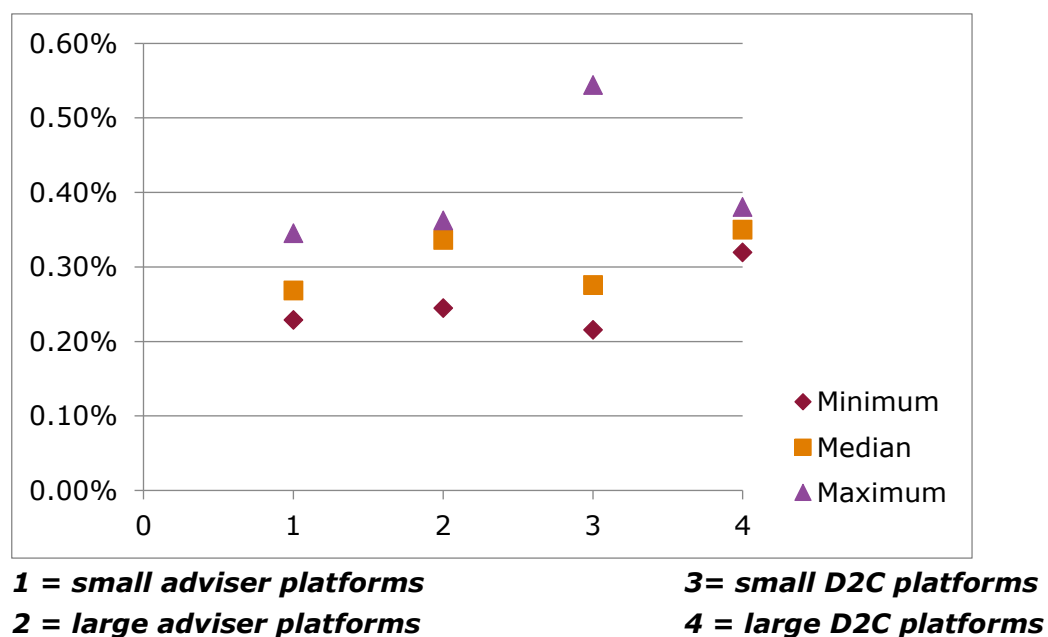
Source: FCA

Price proxy by firm type

41. We analysed the dispersion of our price proxy on a number of different firm metrics, the majority of which showed no noticeable trend: time in the market, profitability, vertically integration.
42. In figure 4.10 below we illustrate the range and median price proxy figures for large and small D2C and adviser platforms for 2016. The large vs small categorisation is based on AUA. The largest spread of price proxy is displayed by the smaller D2C platforms. The median figures for each group are higher for the larger than the smaller firms.

²⁶ Based on 15 to 19 platforms

Figure 4.10: Retail revenues / AuA (2016), by size and type



Source: FCA

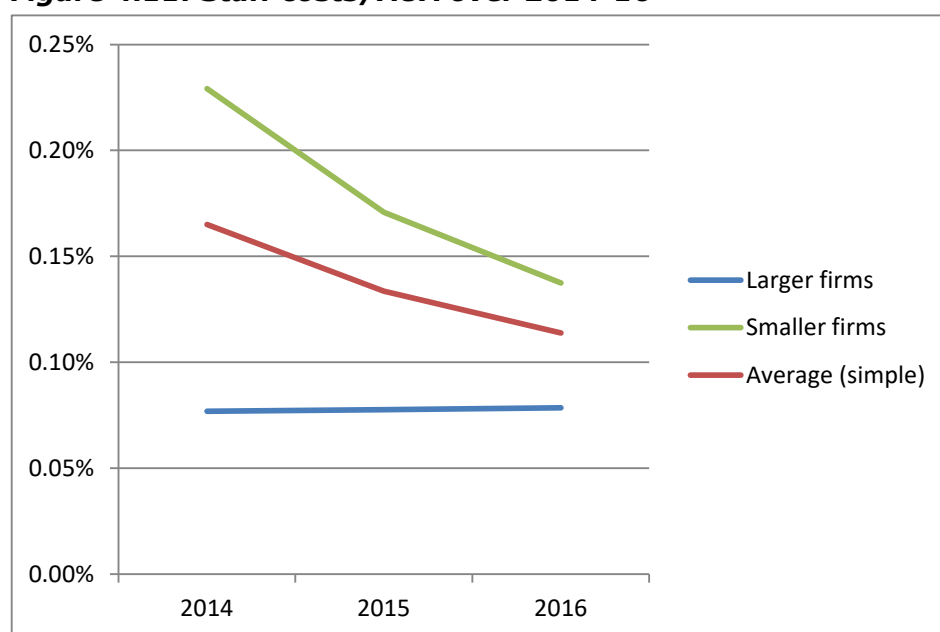
Analysis of platform operating expenses

43. Platforms typically incur 3 main categories of operating expenses: costs relating to staff, technology and marketing. Operating expenses vary widely amongst platforms, meaning that cost control is a key differentiating factor for financial performance.

Staff costs

44. Staff costs are the largest cost for most firms, representing on average 32% of the total cost base. This proportion varies amongst firms, between around 9% to 64% of firms' total costs. On average, staff costs stand at 11 bps, expressed as a proportion of AUA (2016).
45. There are two main factors which explain the variation in staff costs. First there are economies of scale. Staff costs are significantly lower for larger firms than the industry average, as illustrated in figure 4.11. Second, firms have reported staff costs in a heterogeneous manner. For some firms, they cover any employee-related expenses (such as salaries, share-based payment expenses, bonuses, pension and benefits) across all functions (eg both back and front office). For other platforms, they mainly correspond to the costs of rewarding operational staff administering new and existing clients.

Figure 4.11: Staff costs/AUA over 2014-16



Source: FCA

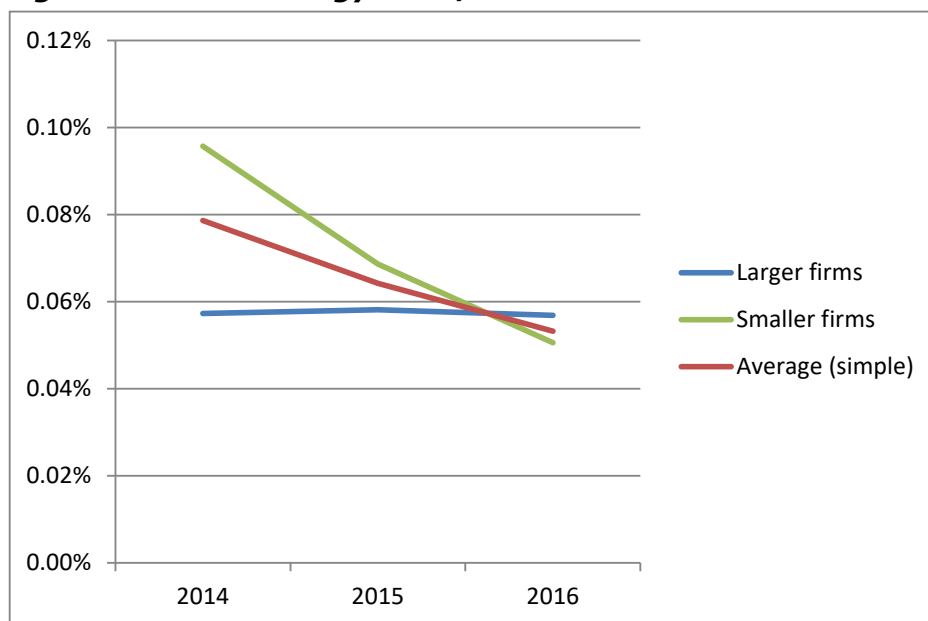
Technology costs

46. Technology represents another significant operating expense. It makes up on average 15% of the total cost base, and varies significantly amongst firms, ranging from 3% to 47%. On average, technology expenses stand at 5bps, expressed as a proportion of AUA (2016). They relate to both IT spent in back office functions (administration services) and front office areas (establishing and managing the digital interface with

clients). We explored how technology costs diverge across firms and whether they are incurred as a fixed or variable expense.

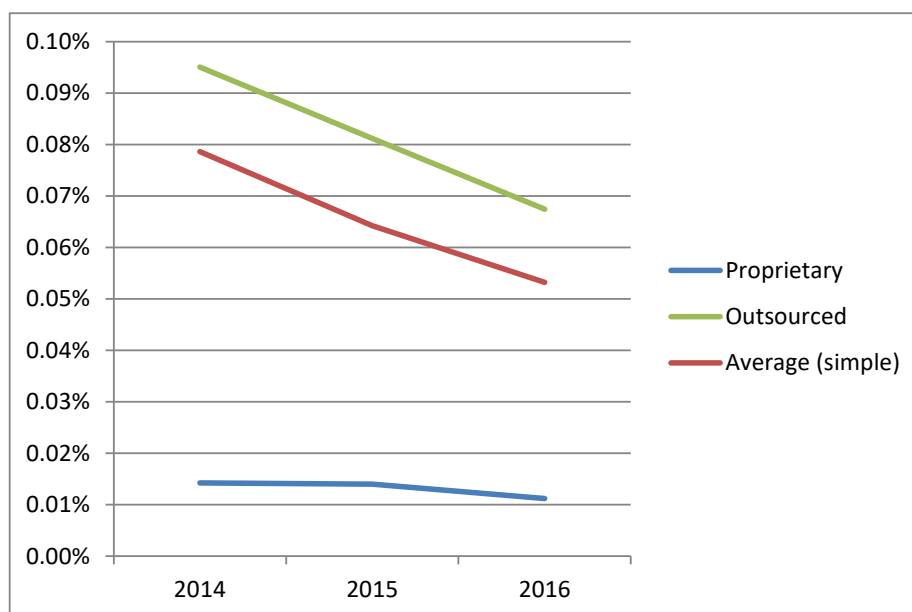
47. We see two main factors driving differences in technology costs. First, approximately half of the firms in our sample are currently undergoing a replatforming programme, or recently finished one. In the absence of granular data, we are not able to distinguish between ongoing technology costs and non-recurring expenses attributable to replatforming programmes. Such plans tend to cover a multi-year period (typically 3 to 5 years), and are capital intensive (typically multi-million pound projects). They are intended to improve efficiency and modernize the platform in line with latest market developments (eg mobile access, streamlined customer experience).
48. Second, we have 2 competing economic models within the investment platform market: proprietary and outsourced technology. A minority of firms rely on proprietary technology for their platform business (only 6 firms in our sample). Full or partial outsourcing of technology is the favoured approach, with 14 firms in our sample choosing that strategy. There are different degrees of using third party technology companies, from a strong reliance on providers to more hybrid strategies. In the latter case, a firm would typically combine outsourcing of back office functionalities (eg custody, settlement and various administration services) with in-house development of client facing functionalities (eg portal for clients and advisers, messaging services and equity trading).
49. We observed lower technology costs for firms adopting the proprietary model, standing at 1bp (expressed as a proportion of AUA in 2016 terms). We see two driving factors for this variation in costs. First, for platforms relying on the proprietary model, a portion of the technology cost is capitalised at inception and amortised in subsequent years. Given that this pool of firms adopted this strategy mostly in the first decade of the 2000s, a portion of the initial capital investment is now amortised. Second, it is possible that the costs attached to the staff supporting the technology function was reported under staff expenses under the proprietary model, while the equivalent cost is outsourced for firms that adopted an outsourcing strategy. A number of firms have moved from proprietary to outsourced technology, suggesting that not all firms considered it the optimal solution to maintain their own proprietary technology.
50. In contrast, technology costs for firms adopting the outsourced model stand at 7bps on average, expressed as a proportion of AUA. This is consistent with the feedback from a couple of technology firms. Outsourced services are typically priced as a licensing activity, with an initial set-up fee (incurred for a few years), and a subsequent usage fee for the remaining lifetime of the contract (usually 10-15 years). Generally these costs are ad valorem, with some tiering mechanisms based on the level of AUA. Consequently, the outsourced technology market allows a platform to incur technology expenses primarily as a variable expense, compared to a fixed cost under the proprietary model. This allows firms to lower their degree of operating leverage.

Figure 4.12: Technology costs/AUA over 2014-16



Source: FCA

Figure 4.13: Technology costs/AUA over 2014-16



Source: FCA

Marketing costs

51. Marketing costs are the third biggest operating expense, representing on average 6% (ranging from no expenditure to 31%) of firms' total cost base. On average, marketing expenses stand at 2bps, expressed as a proportion of AUA (2016).
52. We investigated this cost category to gain insight into firms' customer acquisition strategy. There is no single definition of which costs fall into customer acquisition, but

marketing expenses is a common key component. Sales expenses are also a central component when the firm includes a business development team. As a result, we estimated marketing and sales costs per net new customer over 2013-16. It stands on average at £120 per net new customer (2016), with large variation by firms. It is of a similar order of magnitude to the total acquisition costs provided by 8 firms. Overall, we observed that the largest firms tend to have a larger marketing budget than industry average. It is likely this enables the largest firms to market their offering more aggressively to maintain and grow their market shares.

Figure 4.14: Marketing costs/AUA over 2014-16

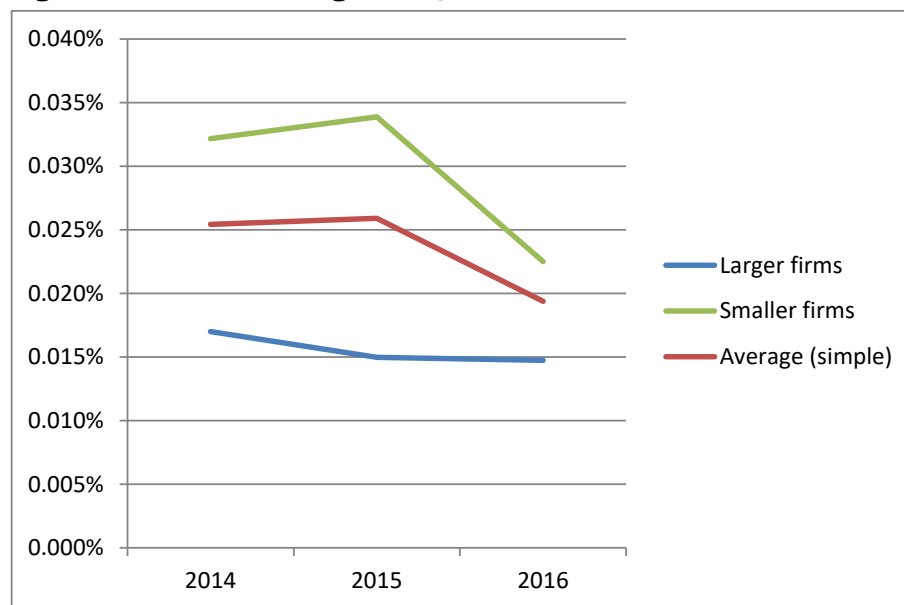
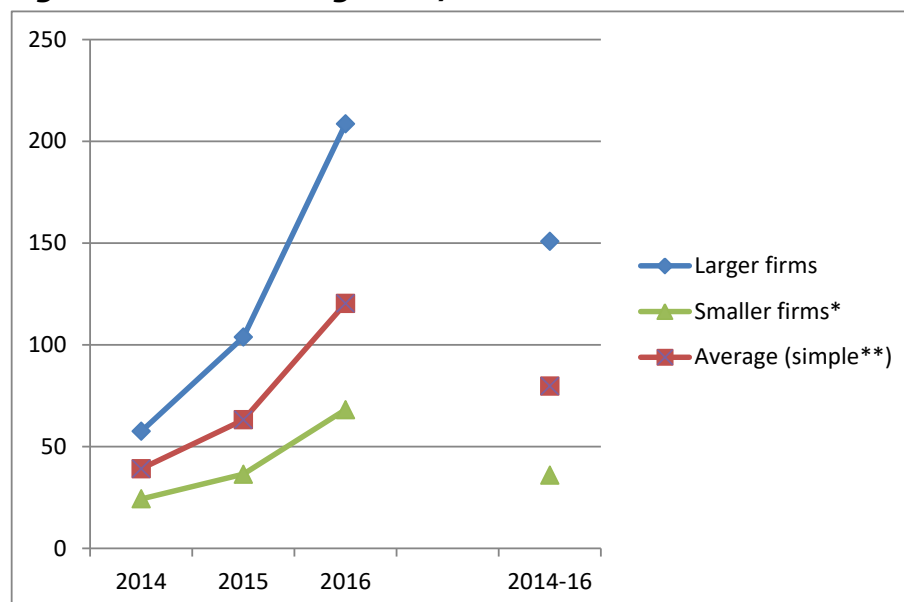
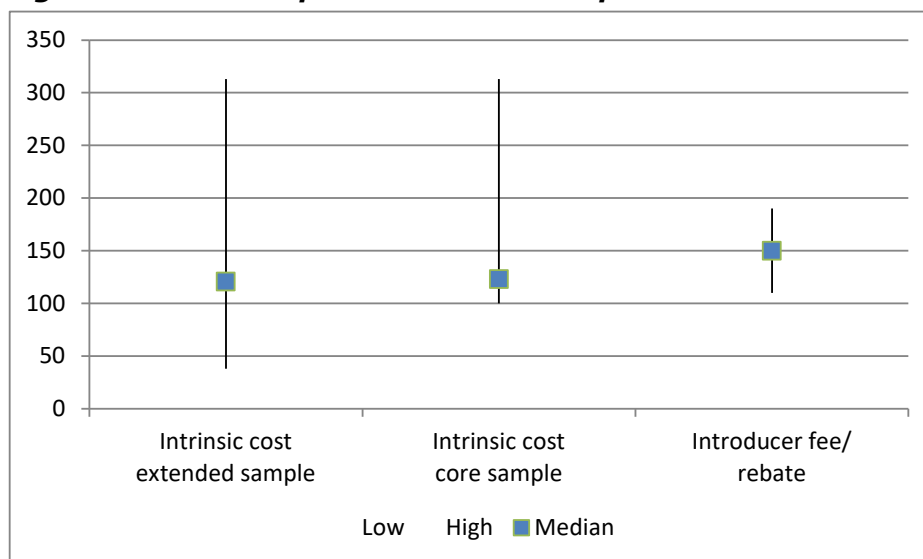


Figure 4.15: Marketing costs/Net new customer over 2014-16



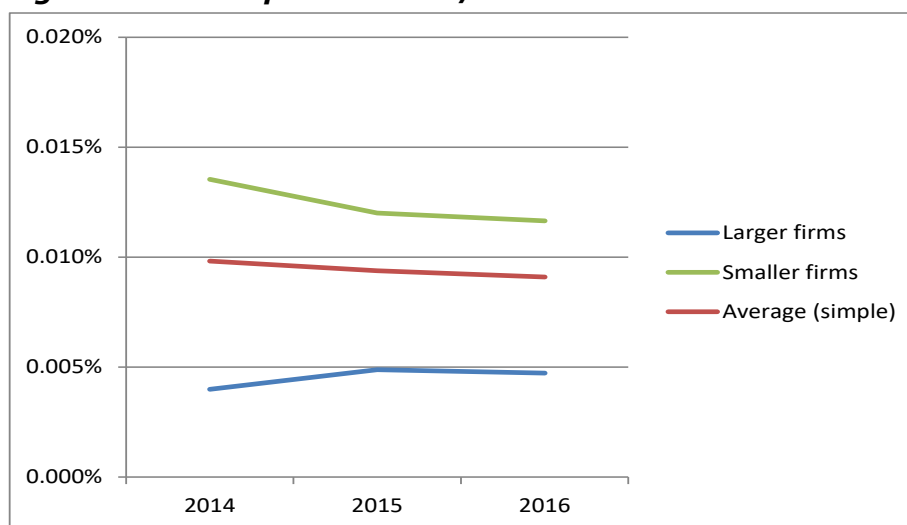
Source: FCA

Figure 4.16: Self-reported customer acquisition costs

Source: FCA. Note: the extended sample includes 40 firms, while the core sample is based on the 20 firms retained throughout the financial analysis

Regulatory and compliance costs

53. We also looked at regulatory and compliance costs. 4 firms in our sample listed the volume of regulatory intervention within their top 3 concerns about how regulations have limited the ability of firms to compete with other platforms and distributors. We found that these costs were not significant, representing on average 2% over 2014-16 (ranging from no expenditure to 8%) of firms' total cost base. On average, they stand at approximately 1bp, expressed as a proportion of AUA (2016).
54. However this methodology does not necessarily capture the full cost incurred by compliance-related work. For instance, this would not include the time spent by staff not part of the compliance department but involved in compliance-related queries. Also, it does not take into account the economic cost of regulatory capital.

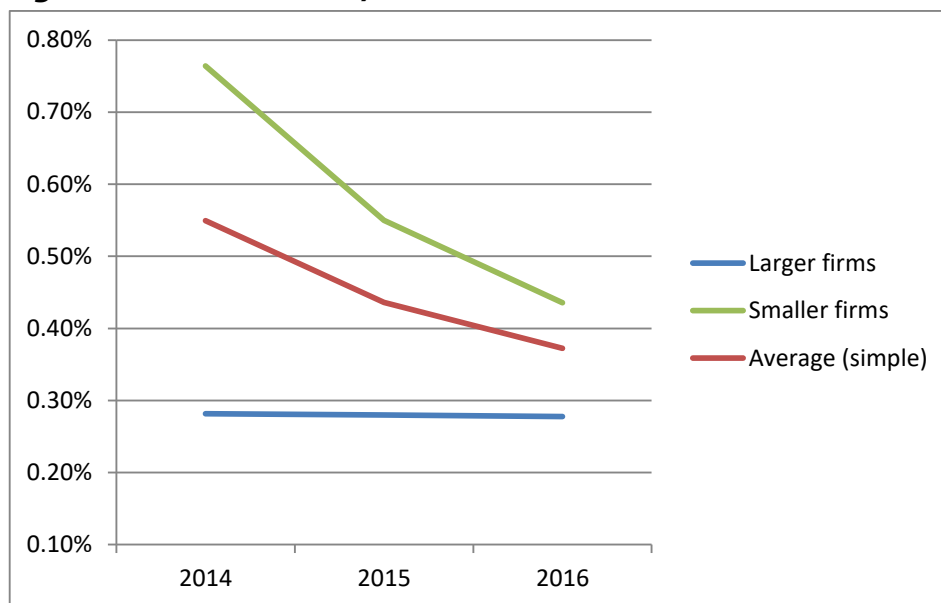
Figure 4.17: Compliance costs/AUA over 2014-16

Source: FCA

Total costs

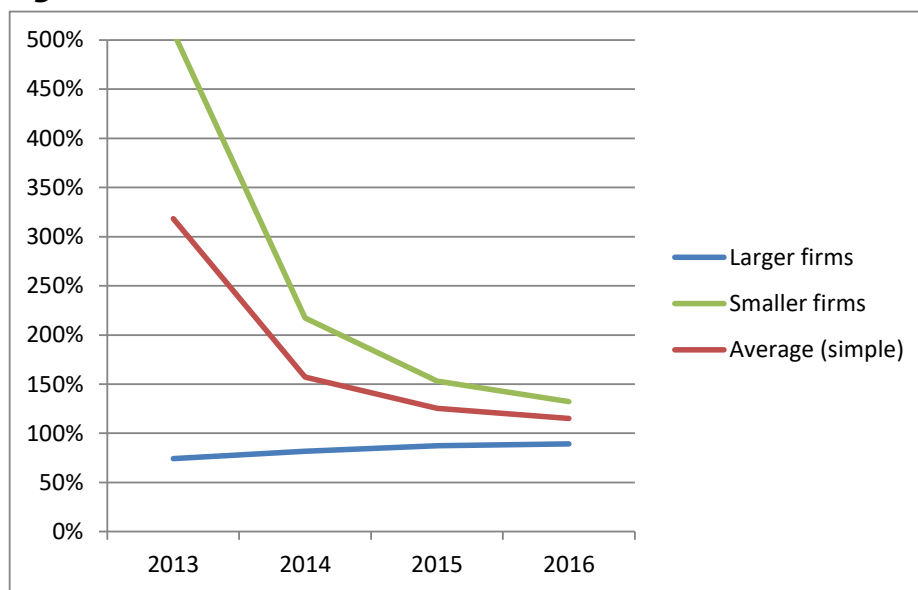
55. Overall, total costs expressed as a function of AUA varied significantly across the sample and over time. For the 8 largest firms, cost per AUA stands on average at 28bps across 2014-16, compared to 58bps for smaller players. Interestingly, costs remained flat for largest firms, while they decreased for smaller players.
56. We observe large variation in cost efficiency within our sample, depending on the size of firms. Looking at cost-to-income ratio (CIR) is one way to measure efficiency. CIR stood on average at 86% over 2014-16 for the 8 largest firms, compared to 191% for smaller platforms.²⁷ This suggests that largest firms have a higher capacity to control their cost through our period in order to generate profits. However, the strong improvement observed for smaller firms over the period is noticeable, even though they have not been able to fully close the gap compared to larger firms in terms of efficiency by 2016. We note that two factors are impacting CIR as a measure of cost efficiency, that is to say the complexities around cost allocation for vertically-integrated players (see paragraphs 9 - 11) and the cost associated with large replatforming plans (see paragraph 47).

Figure 4.18: Total costs/AUA over 2014-16



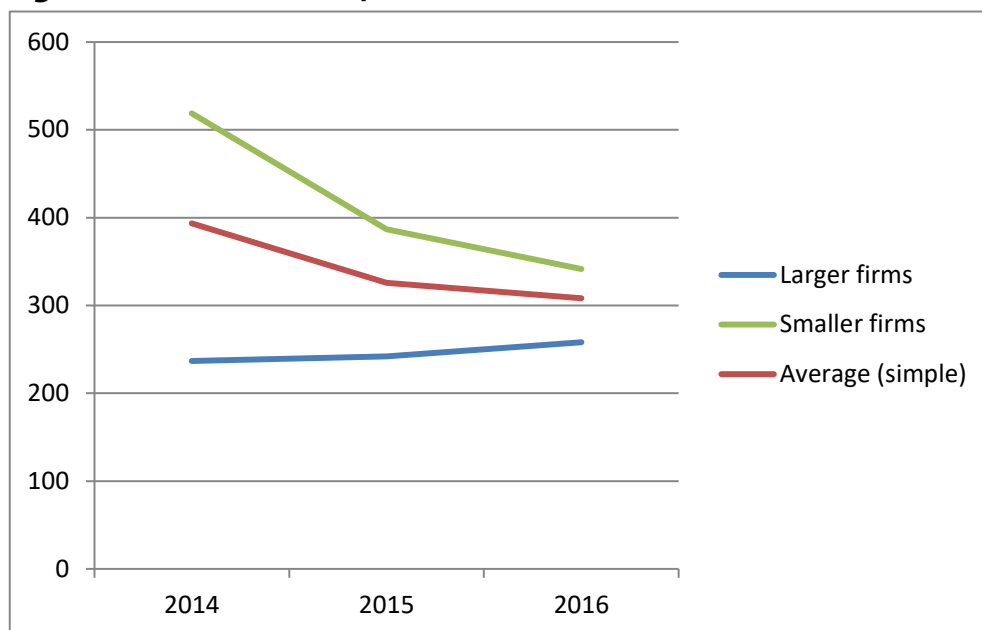
Source: FCA

²⁷ Excluding 2 outliers. Within the financial analysis, we observe that 2 firms are outliers compared to the rest of the sample, in terms of total revenues per AUA and operating profit per AUA. This is a function of their internal methodologies for reporting revenues and costs in the context of our project. As a result we decided to exclude them from some analysis.

Figure 4.19: Cost-to-income ratio over 2013-16

Source: FCA

57. Our sample of firms as a whole reported falling cost per AUA over the time horizon, suggesting that the industry is becoming more efficient over time. This point is substantiated by two other pieces of analysis. We observed a declining average cost-to-income ratio (from 318% in 2013 to 115% in 2016) and declining average cost per customer (from £393 in 2013 to £308 per customer in 2016) for our sample of firms. As flagged earlier, there are variations across the sample. The improvement for the entire sample mainly reflects improved cost efficiency of smaller platforms.

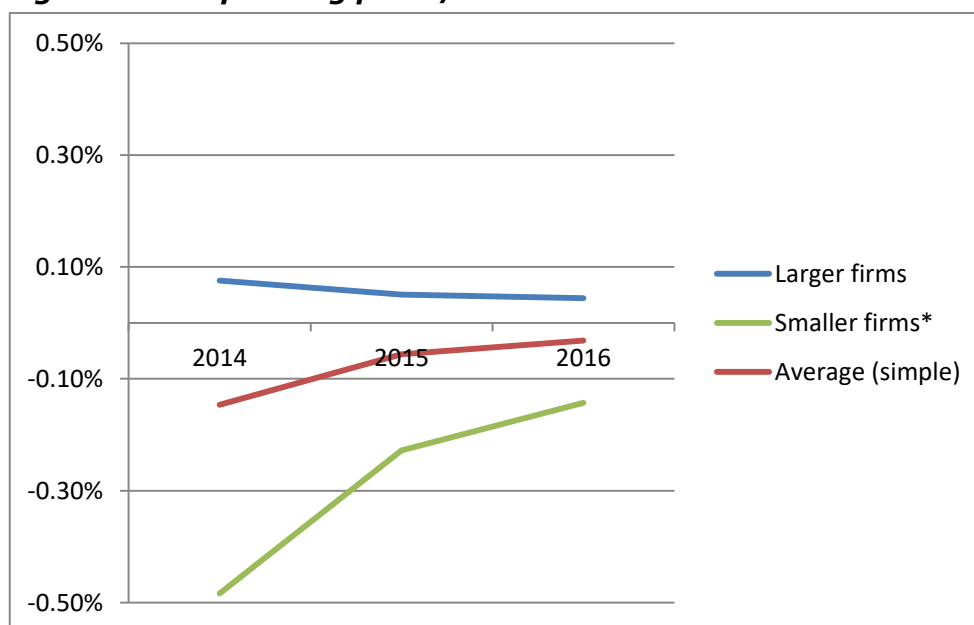
Figure 4.20: Total costs/customer number over 2014-16

Source: FCA

Financial performance

58. We observed a relationship between firms' profitability, scale and maturity.
59. Financial profitability varies significantly across our sample. Across our sample of 20 investment platform firms, we observed 8 firms with substantial positive contributions to operating profit over 2013-16. Another group of 7 firms had total costs significantly in excess of revenues. The remaining 5 firms posted an operating profit that was close to or slightly above zero, pointing to a situation around break-even point on operating expenses.
60. Trends in operating profit are variable amongst firms. For 8 of the largest players, operating margins are broadly flat across 2013-16. For most of the remaining firms, operating margins improved over our time horizon, from an initial situation of substantially negative margins. But we note that not all firms who reported negative, below average margins were able to recover towards a positive level in the later years.

Figure 4.21: Operating profit/AUA over 2014-16

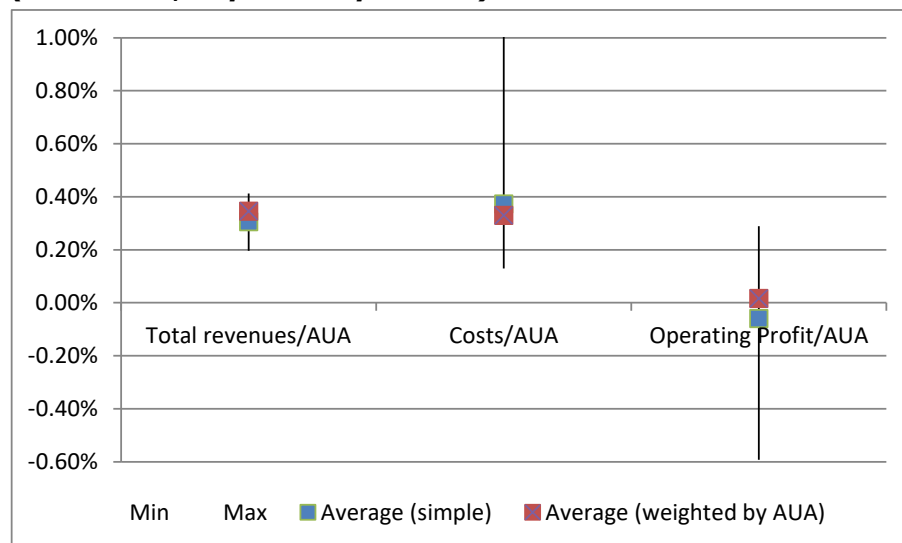


Source: FCA (2 outliers²⁸ excluded within smaller firms)

61. We considered the relationship between profitability, scale and maturity of firms. We observed that larger firms tend to be more profitable than the industry average. This is represented in figure 4.21. With quite a limited variation in total revenues as a proportion of AUA, the key differentiating factor for a firm's profitability is the size of its cost base.

²⁸ Within the financial analysis, we observe that 2 firms are outliers compared to the rest of the sample, in terms of total revenues per AUA and operating profit per AUA. This is a function of their internal methodologies for reporting revenues and costs in the context of our project. As a result we decided to exclude them from some analysis.

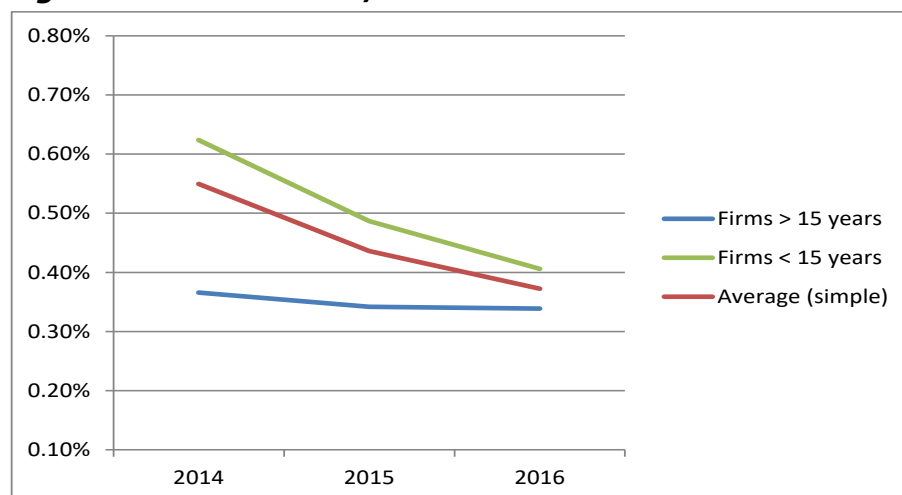
Figure 4.22: Variance in costs is much higher than variance in revenues (2016 data, expressed per AUA)



Source: FCA (2 outliers²⁹ excluded in the metric revenues per AUA and operating profit per AUA)

62. We observed falling cost per AUA as AUA increases. But there are some examples of small firms with low costs comparable to large firms. We hence consider there to be a weak negative relationship between average costs and scale.
63. We also explored the relationship between profitability and life stage of the company. Scale and maturity are closely intertwined but not fully equivalent.³⁰ Mature firms tend to have on average larger AUA than recently launched firms (even though there are some examples of firms who have operated for more than 15 years and retain an AUA under £15bn. We concluded that established firms have lower total costs relative to AUA on average, leading to higher level of operating profit, compared to the industry average. The average firm tenure was 15 years, as of 2016.

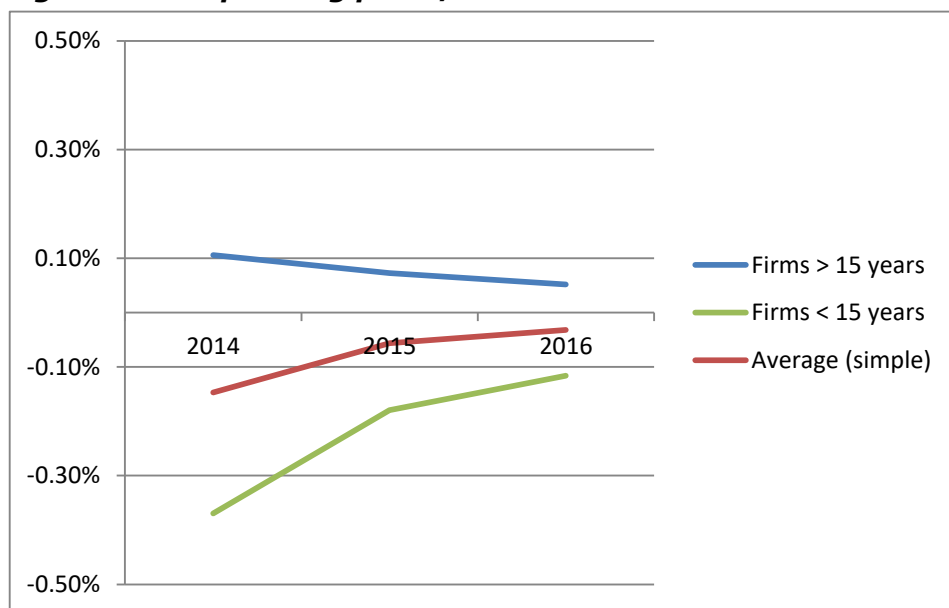
Figure 4.23: Total costs/AUA over 2014-16



Source: FCA

²⁹ Within the financial analysis, we observe that 2 firms are outliers compared to the rest of the sample, in terms of total revenues per AUA and operating profit per AUA. This is a function of their internal methodologies for reporting revenues and costs in the context of our project. As a result we decided to exclude them from some analysis.

³⁰ In our sample, we classify 8 firms as the largest ones and 11 firms as the most mature ones. Between the 2 groups, 7 firms are overlapping.

Figure 4.24: Operating profit/AUA over 2014-16

Source: FCA

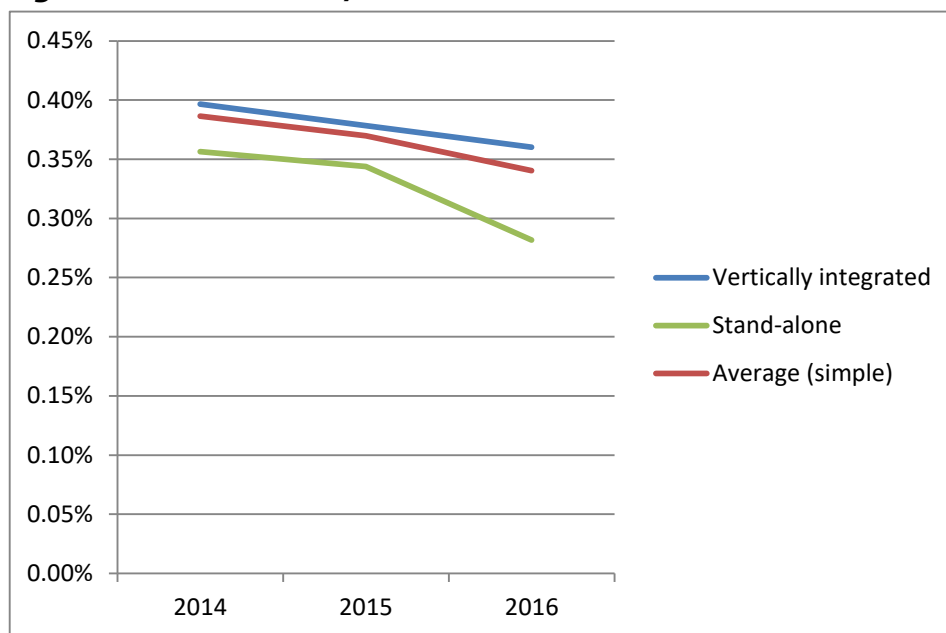
64. Overall, we observed some relationship between operating profit and scale, namely that smaller platforms tend to have lower operating profit margin than larger ones on average. However there are examples of smaller firms who manage to have similar or a higher level of operating profit margins than larger players. This suggests that there are other factors influencing financial performance, as evidenced in the following sections. We also observed a higher level of profitability amongst firms that have been established for a longer time period than the industry average, which highlights that life stage for a firm may be a key factor in its profitability.

Financial performance and vertical integration

65. With a majority of players in this sector being vertically integrated (three quarters of our sample), we explore the relationship between financial performance and vertical integration. A couple of firms also raised vertical integration along the investment value chain (ie alongside asset management and advice) as a source of concern for this industry.
66. In terms of revenues per AUA, we observed a low level of difference between vertically integrated and stand-alone players. On average, revenue as a proportion of AUA stood at 32bps for vertically integrated firms (excluding 2 outliers), compared to 28bps for stand-alone players (2016). We also observed no identifiable pattern in terms of revenue growth – vertically integrated firms have not been able to grow at a higher rate than stand-alone firms (33% and 40% revenues CAGR³¹ 2013-16, respectively).
67. On the cost side, however, firms reported a more substantial difference. On average, cost per AUA stood at 41bps for vertically integrated firms, compared to 27bps for stand-alone players (2016). Looking at the key cost components, this difference is observed for staff, technology and marketing costs. Staff costs have the most significant impact. Consequently, only 1 out of the 5 stand-alone platforms had negative operating margins in 2016, compared to 9 out of 15 vertically integrated firms. As a result, vertically integrated firms tend to report, on average, lower operating profits than the standalone platforms.

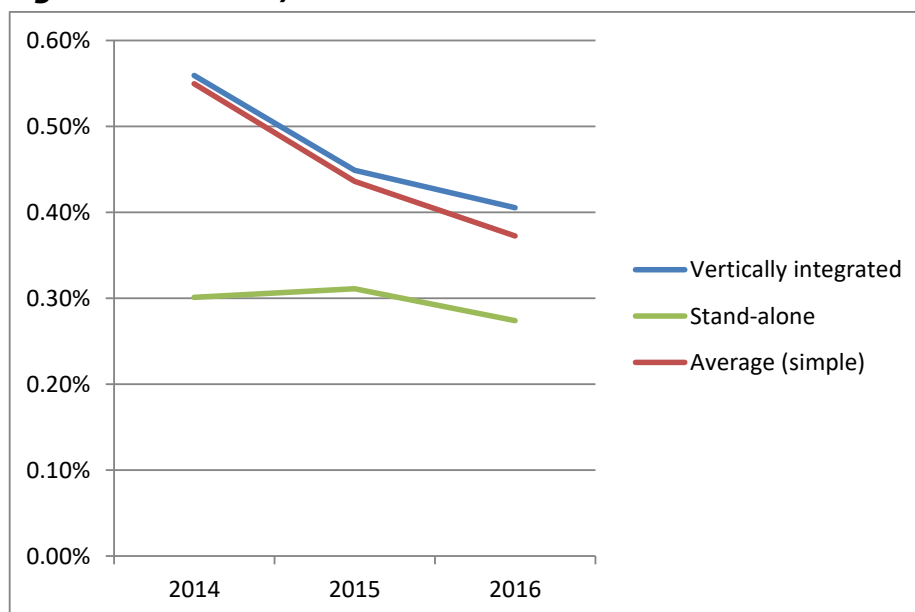
³¹ Compound annual growth rate

Figure 4.25: Revenues/AUA over 2014-16



Source: FCA

Figure 4.26: Costs/AUA over 2014-16



Source: FCA

68. There are two possible explanations for this observation. First, vertically integrated firms are able to cover their cost base through a wider pool of income, such as asset management and/or advice services. In particular, the Asset Management Market Study, established that asset management generates substantial return on capital employed, ranging between 10-25% over 2010-15, with a money weighted average ROCE of 12.8%.³²

³² Based on adjusted return on capital employed. See Annex 8 of the Interim Report of the Asset Management Market Study for further details on methodology: www.fca.org.uk/publication/market-studies/ms15-2-2-annex-8.pdf

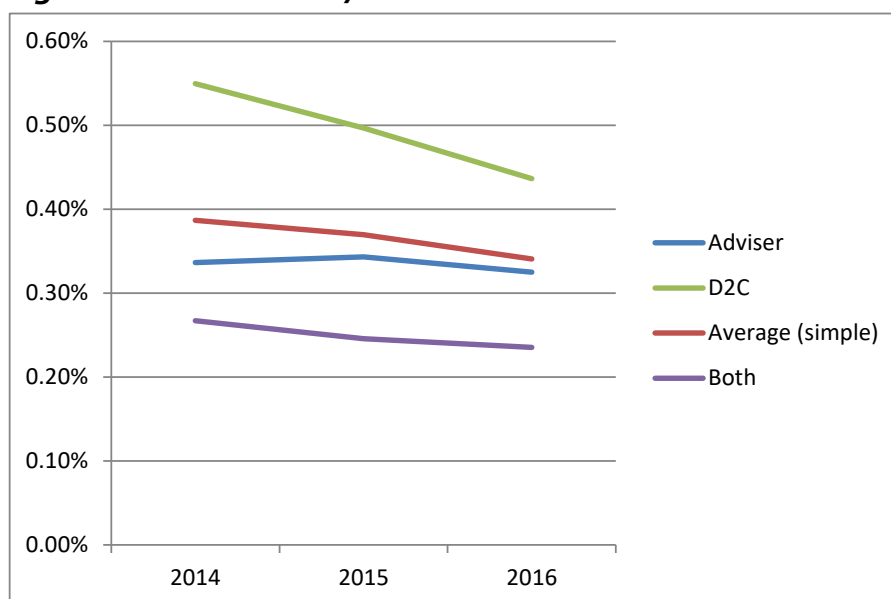
69. Second, our findings may reflect the challenges underpinning cost allocation. With the platform business being the part of the value chain closest to retail customers for vertically integrated groups, management teams can attribute some costs to the platform entity. See paragraphs 10 and 11 for further details on cost allocation challenges.
70. Overall, we observed relatively little difference between standalone and vertically integrated firm revenues on average, but we found that vertically integrated firms tend to report higher costs on average. As a result, they report, on average, lower operating profit per AUA than standalone platform firms.

Financial performance across D2C and adviser platforms

71. We assessed whether there are differences in financial performance between D2C and adviser platforms. Looking at the differentiation between adviser platforms and D2C firms, revenues remain within a narrow range. Average revenues per AUA stood at 33bps and 44bps for 2016, respectively, based on pure play D2C and adviser platforms, setting aside firms involved in both markets. However, D2C firms grew at a slower pace than pure adviser platforms, with 18% and 48% revenues growth CAGR³³ over 2013-16, respectively. This is consistent with a slower growth in AUA for the D2C segment as a whole.
72. Compared to the average cost per AUA at 37bps across the whole sample (2016), 5 out of 10 adviser platforms reported higher costs than the industry average, compared to 3 out of 6 D2C platforms. We concluded that there is limited differentiation in costs between the D2C and the adviser segments.
73. Reviewing firms' qualitative answers, platforms expressed mixed views on the matter. Only 3 firms argued that there is a different cost base to serve these two segments. Two firms argued that the costs of supporting an adviser platform are generally marginally higher. They explain this difference by enhanced support received in the adviser space, due to differentiated products and services. The additional costs relate both to personnel costs (customer services) and systems' costs (technology, driven by adviser specific functionalities). Another firm argued the opposite. In its experience, it is more expensive to serve a customer without an adviser, because intermediaries provide ongoing support to retail clients.

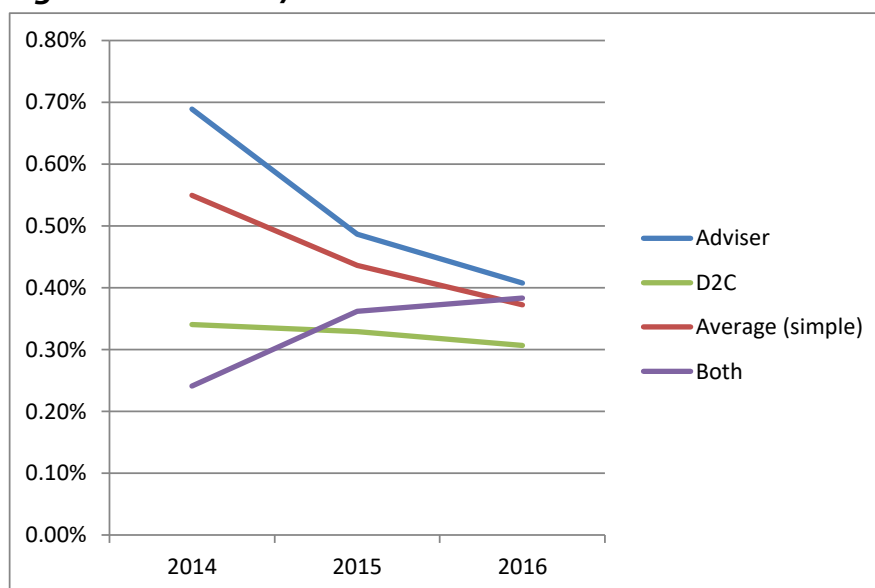
³³ Compound annual growth rate

Figure 4.27: Revenues/AUA over 2014-16



Source: FCA

Figure 4.28: Costs/AUA over 2014-16



Source: FCA

74. Overall, we observed limited differentiation in revenues and costs per AUA between the D2C and the adviser segments. From a financial perspective, they represent modest variation of a similar business model. We believe that firms' idiosyncrasies, such as level of maturity and efficiency of cost control measures, are more important factors explaining profitability.



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12 Endeavour Square London E20 1JN
Telephone: +44 (0)20 7066 1000
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