Finextra roundtable 2008

On 25 September, Finextra hosted a roundtable discussion with a number of leading advisors and investors in the financial technology sector. The discussion covered a review of how the number, scale and profile of deals has changed after one year of the credit crunch, and what trends we are likely to see in 2009 and beyond.

The discussion was chaired by Elton Cane, strategy director and content producer, Finextra. Participants were:

- Chris Brooke, partner at Goldenhill Technology Advisors, whose recent deals include advising Princeton Financial Systems in its acquisition of Aquin Components
- Ting Le Deng, associate director at UBS Investment Bank's technology practice
- Stephen Byrne, principal at Vitruvian Partners, a mid-market focused private equity firm that closed its inaugural fund at EUR925million in February this year

Finextra: *As people involved in investing in and advising the financial technology sector, how difficult are things at the moment and are there any signs for optimism?*

Chris: There are still deals being done. They tend to be done for very good strategic reasons. We've seen some in the past 2-3 weeks where various companies have bought at significant valuations, but there's a very clear reason why they've done it. Where Advent bought Tamale, for example, there was a healthy valuation, but there's a very clear strategic rationale.

There's certainly going to be a fall off in the number of deals generally, but the valuations are holding up for the right kind of deal.

Finextra: *Do we all agree on this?*

Ting: I think so. The number of deals has certainly fallen. But the number of strategic acquirers who are active has actually gone up. If you take the recent GL Trade and Fermat processes - there was a lot of private equity interest, but financing made the transactions difficult. Obviously market uncertainties made it uncertain too. But the strategic buyers have seen that for the first time in a few years they could get a good asset for a good price. I wouldn't say it's a premium price that they paid, but it's a good price.

Finextra: *So the strategic buyers are in a better position now because private equity's pulled back due to financing difficulties?*

Ting: Yes, I also think there's a bit more due diligence needed. What used to be recurring and guaranteed contracts, as we've seen in the past few weeks, are not as concrete as they used to be. So again, financing banks and investment committees will be more closely considering the viability of those contracts. Industry consolidation makes it more complicated and probably reduces margins too for some of the contracts.

Stephen: From a private equity perspective, the players are still interested in the market. It's just that much harder to do some of the big deals that require leverage. But you only need to look at a deal like SSP to see there are still private equity firms doing deals. If anything the mid-sized deals that have been less affected by the removal of leverage from the market can still continue.

While it is tough times, there are still themes such as risk that are becoming more of a focus. So it's not that there are no areas where there will be growth.

Chris: I think also that buyers are still there for quality assets, I think the issue is that the risk appetite has gone down. People are much more interested in buying companies with sustainable profitability whereas in previous years they might have taken a risk in buying some technology or capabilities. Now they want recurring revenue, profitability, quality contracts with customers, and preferably without too much concentration with some of the large investment banks.

Finextra: *Will that make it more difficult for start-ups with innovative technology, but not an established profit track record, to get funding and achieve exit strategies?*

Chris: Good question. I think it is going to get harder. IT budgets are getting squeezed except in a number of areas - as Stephen mentioned, risk and regulation. If you're focused on these areas in the next 2-3 years you're probably going to be in a good position. I think there is going to be more regulation. There is no doubt about that.

Finextra: *We've seen in the news reports about front-office IT spending falling. Previously it had been more about rate of growth slowing, but do you think it will really scale back further due to recent events?*

Ting: I think that other than regulatory imperatives there are also areas within the bank where we do need to make investments. Good companies that can really help with efficiency especially those in areas such as back-office processing and corporate actions. Even though sales cycles have lengthened and initial deployments are smaller than expected, companies with good solutions that help reduce costs and improve efficiency are still seeing strong demand.

If you look at some of the bigger fintech vendors such as SunGard, they're actually beginning to streamline their activities a little in order to improve profitability. In the past few quarters they've done very well from pursuing this process. And this obviously creates some opportunities for smaller vendors to pick up clients that they're not actually serving any more. I think that's a positive amid all the doom and gloom.

Finextra: *And I guess as large vendors like SunGard streamline to save costs, they can also help address some of the criticism they've faced about offering a joined-up service to customers across the disparate units within the organisation.*

Ting: I don't believe they're integrating optimally yet anyway, but they're doing a good job of bringing together the products and sales teams and making sure their products are profitable. If you look at their last few quarters they are very positive.

But I think all the vendors will see some pain. It will be harder and longer to sell, especially long-term replacement projects that require a lot of up-front investments.

Finextra: *From the recent wave of emergency M&A within the banking sector, are there going to be any particular opportunities arising from consolidation of IT systems and business processes?*

Chris: I think the issue for the vendors is really the concentration risk. The bigger banks are getting bigger - Merrill being bought by Bank of America, part of Lehmans now with Barclays ... there are vendors that are quite exposed to this market and have concentration risk.

One of the things already happening is an increased focus on tier 2 and tier 3 banks. Certainly the vendors that can target that part of the market with effective solutions and services, and provide lower cost of ownership, will be the most successful over the next couple of years and are the ones that other companies are more interested in acquiring - often to get capabilities such as offering hosted solutions.

Finextra: *As well as diversification to a smaller financial institution customer base, I suppose vendors who have geographic diversification - not just serving Western Europe and North America - will do better.*

Chris: By definition financial services is a global market and if you've got customers in different markets that certainly helps. The Asian market has been growing for the past few years. Again a benefit of a hosted model is that you can offer solutions more effectively on a global basis without necessarily having the same presence globally.

Stephen: With the big M&A deals happening there's a likelihood that the banks will default to not buying new software, but actually focus on bringing in services to make sure the pieces that they've just bought will interact with the rest of the financial reporting systems. You may see a swing in those banks away from buying software to buying services. I imagine that priority one is to make sure what they've just bought is talking to what they had before and make sure it all works. Then worrying about what the ideal solution is will be more of a long term issue.

Finextra: *So this will play more to the strengths of companies like IBM and the big systems integrators?*

Ting: There will also be a lot of review of in-house development, looking at whether that's viable long-term. The majority of spending on software at the bigger banks is still in-house. And I think once the market conditions have improved there will be more time spent looking at whether the costs of this are worth it in the long term.

Some of the systems developed in-house are still not as robust as outsourced solutions and third-party solutions have the advantage of being more tested across the board and being integrated better with other products. So this is one of the questions that will be examined over the next few years.

Finextra: *Looking beyond the provision of software and services vendors to the industry, another area in financial services where we're seeing a lot of M&A activity is in the exchange space and intermediaries. Among the exchanges do you think we've seen the end of the most recent wave of cross-border acquisitions by the bigger exchange groups?*

Chris: I think it will carry on. Vienna Boerse buying the Budapest Stock Exchange just recently for example. There are various pressures on that market - on the one hand the driving down of costs that consolidation helps, and then you've got liquidity fragmentation and trading venues popping up all over the place. So it will carry on, but at the same time the large exchanges are still looking to vertically integrate downstream and upstream - things like SOR and algo trading.

Stephen: A few of the bigger players have indicated to the markets that their big buys are done for now and they need some time to consolidate. So you'll see the biggest acquirers pause for breath while they integrate what they have. You're right that the regional consolidation and smaller players coming together will continue and we'll also see exchanges taking strategic stakes in some of the emerging markets and markets they haven't tapped yet - for example the Middle East and Latin America.

Ting: Particularly in the Central and Eastern Europe market which is less consolidated there's a lot of activity. In addition to Vienna, which we mentioned, Warsaw Exchange is also active.

I think there will be consideration towards whether some of these alternative venues would fit with a traditional exchange and it's something they'll have to consider over the next couple of years. I think that's probably slightly in the future.

Everyone is thinking about what's going to happen. Given MiFID, the barriers have come down. Chi-X has generated about 11% of the trades in the FTSE 100 in Q1. And that's before Turquoise which is a bigger, more potentially potent player, went live. So you can see how LSE will potentially lose a significant proportion of its trades by the middle of 2009.

Finextra: *In the US when the large exchanges were faced with dwindling market share due to competition and better technology, their reaction was to buy and absorb them. How likely is this in Europe, exchanges buying up new entrants?*

Chris: Traditional exchanges have to broaden their range of services. The deal where LSE bought a reference data vendor, for example. Offering wider services is certainly something they need to do, with the background of the buy-side being de-coupled from the sell-side through providers such as Liquidnet. They've got to offer a much more competitive offering and I think that's what they're doing through acquiring services.

Ting: If you look at some of the alternative venues - many were set up by the big banks, JVs with other financial institutions - actually the competition is actually encouraged by those who use the service i.e. the banks. Exchanges would obviously like to buy the competition, but they may be faced with some obstacles and resistance from the big banks. The LSE was probably overpriced for a number of years and now we're getting to a level where the competition is healthy for everyone - the LSE has reduced its cost base and become more competitive and the connectivity is much faster.

Then there's acquiring technology. NYSE Euronext is a prime example, taking over the Atos Euronext joint venture, buying Wombat ... and I think they continue to buy good pieces of technology to offer to their clients.

Finextra: *And continuing to sell technology to other exchanges in emerging markets too.*

Ting: Someone like OMX is a good example

Finextra: *Another area we're seeing a lot of activity is in the payments processing and software space - everything from Moneygram expanding internationally with Spanish acquisitions to ACHs merging, investing in software acquisitions and opening up to non-bank investors. Do you see this continuing in the current market, or will there be more sitting back and seeing what happens?*

Ting: The payments processing market is one of the most active at the moment, driven by Sepa and also I think that some of the banks that own these assets are under capital constraints and these non-core assets aren't part of their strategy.

I think everyone's trying to build a pan-European presence and with Sepa breaking down all the barriers they can actually build a business of scale across the region, whereas they couldn't previously.

Finextra: *And now that the banks also aren't locked into their domestic infrastructures there is even less reason to be tied into their investment.*

Ting: Yes, now they have choice once contracts are seen out, which will inevitably have its own benefits for them. I think having divested some of their stakes in domestic players it will also help avoid conflict.

Finextra: *I think SIA-SSB in Italy is the prime example of this at the moment. In terms of private equity interest in the sector, is it still attractive to them given the pressure to reduce cost of processing? Or is it likely to be third-party processors or other ACHs coming in as acquirers/investors?*

Stephen: I think private equity can bring a lot of benefits to these companies, similar to some of the themes we see in the exchange space. They can bring in independence, which is increasingly important. These businesses will require funding for M&A and technology investment and their existing shareholder may not wish to fund that.

The other thing that private equity can bring is an incentive structure and commercial structure that is more aligned to building these businesses into commercial competitive businesses for the future. So there are a lot of good reasons why private equity could be involved in this sector.

Ting: There is opportunity not only because of fragmentation but because there's scope for the private equity firms to get involved in building pan-European payments infrastructures. I think some of these firms have hired people experienced in this space to help them accelerate the process. And I think the market is fundamentally attractive because with scale there are a lot of benefits. It can still be a very profitable market if you have the scale and a very good platform.

Chris: In mobile payments too there are a lot of developments, and that's a market that's going to see a lot of evolution and growth in the next 2-3 years.

Finextra: *And I think that's the area where you're going to see more brand new companies, start-ups, perhaps with VC backing. Because there is no clear dominant player and the market's not mature yet.*

Looking more broadly at seed funding and venture capital, is there much activity in the financial technology space at the moment?

Chris: We're not seeing very much, certainly in the past few months.

Finextra: *Is this just the market, or a lack of new companies worth backing?*

Chris: I think it's just the market and levels of perceived risk.

Stephen: There are quite a few players out there in a lot of these spaces. One of the nice things is that it's dynamic and there is regulatory, strategic technology change. But if you look for example at mobile payments there are quite a lot of companies operating, and when you have a choice of starting or backing the next new one or waiting to see which ones will be the winners, I think it makes it hard for new company funding.

Chris: There's also the debt issue. It has been very hard particularly for small companies to raise debt.

Finextra: *Chris, you mentioned the importance of serving the mid market financial institutions and hosted, software as a service (SaaS) offerings being a key delivery mechanism - how do you see the adoption and level of maturity of this technology?*

Chris: I think customers are becoming much more aware of how those types of solutions work. Look at the insurance market where companies have built SaaS offerings and educated the market that giving your data to be managed by a third party is safe and acceptable. The same thing is happening in the hedge fund market. There are an increasing number SaaS offerings out there. So over the past few years there has been growing acceptance and also the technology for delivery has improved significantly in that time too.

You've now got companies that already offer SaaS that are looking to acquire businesses that they can turn into SaaS using their expertise. And you've got it the other way around too. Companies with mature monolithic solutions are looking for help to offer the solution to smaller organisations. They don't necessarily have that expertise so they're looking to buy companies that do.

Stephen: From an investor perspective this aligns nicely with a desire for predictability in the business model. The traditional big software license sales as part of a big IT project is very hard to diligence in this environment, and very hard to finance. Whereas a more subscription-based business model with the regularity of recurring revenue is actually something that's easier to diligence and invest in.

Chris: There are quite a few of the larger vendors, that in the past have been reliant on the big upfront license fee and then the long tail of maintenance revenues, that have been trying to change this in the past few years. Some have managed, and others are still trying to.

Finextra: *I guess this model is attractive not only to the smaller banks, but also the large tier one players who are in consolidation mode. If they are going to invest in a new project, if it doesn't have the big upfront license cost, that is going to be attractive.*

Chris: Yes, the companies who are currently selling SaaS to smaller financial organisations are expecting that to move upstream.

Stephen: The lower time to implement is also attractive because you generally have to demonstrate a quick ROI for must-have purchases.

Chris: But it does present challenges. Software as a service gives you less flexibility. If you're a mid-sized player maybe you're more ready to accept a best business practice solution, but if you're a tier one, maybe you've got different ways of doing things that don't necessarily fit with the SaaS model. But this is probably going to change as well.

Ting: I think a lot of the investment is going to be dependent on the infrastructure and how some of the infrastructure providers are able to provide what's needed to deliver these services. I think there's certainly been a lot of improvement over the past few years, particularly in software that helps manage the data flow, which has historically been a bit of a problem. Securing that data flow too is quite key to some institutions.

Finextra: *In the financial services outsourcing sector - IT and BPO - we've seen falling share prices, particularly for those suppliers exposed heavily to disappearing financial institutions.*

How do you see the long-term impact of an ongoing financial crisis on outsourcing providers?

Stephen: I think the long-term trends for outsourcing are very much intact. Outsourcing should be delivering a higher quality service at a lower cost. That's totally consistent with banks feeling the need to tighten their belts and be more efficient in what they do. Obviously there will be some IT infrastructure consolidation that may mean that if you're further up the curve in terms of BPO rather than just infrastructure that's probably a more comfortable position to be in. But the trend of banks looking at their infrastructure as they look to cut costs, and considering what other organisations could be doing for them, and at a better price - that will continue.

I think for example a lot of organisations will look at their back-office activities again in light of some of the mergers obviously, but also in light of having to be more focused on how much they cost. But the demands on the back office, for risk and reporting and having access to the right information, continue to increase.

Finextra: *So the onus on back office service providers is to keep up and continue developing their capabilities in data access, risk management and reporting.*

Chris: Also, the line demarking what can and can't be outsourced is shifting more towards the front office. I think that will continue, but the issue is how responsive the outsourced service providers are to the changes that need to be made to allow the outsourcing business to effectively run its client's business.

Payments are a good example, firms can outsource that but they need to ensure that the provider has the right level of domain knowledge. And the company outsourcing also needs to retain enough knowledge so they can know whether the relationship is working.

Finextra: *To round off a discussion like this it is customary to ask for some kind of forward looking statement. But in the current climate I guess it's hard to predict what's going to happen in the next few weeks let alone 6-12 months. ...*

Chris: In terms of M&A there is still an appetite for strategic buyers to buy the right assets. And there are many areas where there's a lot of interest, we've covered software as a service, risk and regulatory compliance for example. People are still looking to buy things and there are companies looking to sell.

In the mid-market there will continue to be deals being done.

In terms of valuations there is certainly pressure, that's inevitable. But those with good technology, quality customers, good contracts, recurring revenues and sustainable profitability in the right areas - these companies will still be attractive to buyers and investors. From our point of view we do have a number of clients that fit these criteria.

Ting: Absolutely. Consolidation will continue. Strategic buyers are more competitive than they were before and will continue to be so. I think the landscape is still very fragmented, so opportunities to invest and grow out platforms are still there. You'll see a lot of vendors come under pressure - even some of the big ones - over the next 6-12 months. We haven't seen any real pain yet, especially in listed companies that are still performing quite well even though their share prices have factored in some attrition.

If it's a prolonged downturn I think there will be more pressure to look at bigger deals between the big players. One of the factors that stop companies doing deals is that they have a very tight selection process and criteria for what they want to buy. But that will probably be loosened over time in pursuit of scale, geographic presence and sometimes even to keep a client in light of market consolidation among the customer base.

I also think in the mid-market space there are still a lot of opportunities for private equity.

Stephen: I agree. It's harder for private equity to use debt to get into the big acquisitions. But if you look at the mid-market, there is still dynamism and growth areas, so private equity will continue to play in this area.

In terms of consolidating within financial technology providers we've seen even in the past few months some private equity players with assets in this sector putting more capital to work to help them continue that strategy.

Finextra: *Well that wraps up today's roundtable. Chris, Stephen and Ting, thanks for your time.*