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DEAL DIMENSIONS

Tech control:

How fintech M&A is shaping the financial future

Foreword

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The financial services sector is undergoing a technology-driven metamorphosis. Highly-publicised security breaches, heightened regulatory oversight and obligations and more stringent capital requirements are forcing the industry to radically rethink its entire structure.

However, these three challenges pale in comparison to the transformative power of technology. Fintech is fundamentally changing financial services.

Nimble disruptors in the form of innovative start-ups have been joined by the world's largest technology companies as they seek to take market share from incumbent financial services providers. Meanwhile, regulatory scrutiny and operational complexity demand new tools and solutions to reduce cost and improve productivity. Digital native customers have exacting demands.

For many financial services businesses – from banks and insurers to private equity firms and family offices – it will not be possible to rise to these challenges purely by looking within. Organisations will need to consider acquisitions and investments to secure access and exposure to the technologies and skillsets required to operate successfully in the marketplace of the future.

The good news is that there is no shortage of innovative fintech businesses pioneering new tools and solutions with the potential to transform every aspect of financial services – both in customer-facing functions and in the back and middle office. However, competition for these fintech stars is fierce. Dealmakers in the fintech sector face tough contests from rivals equally determined to secure the prize assets.

Against this backdrop, Reed Smith has set out to chart the current state of play in fintech M&A. Our exclusive survey of leading executives in the financial services sector identifies the sectors and regions where the competition has so far been most intense, as well as those areas that are likely to be in demand in the months and years ahead. It also focuses on deal drivers and considers the challenges that active participants in this marketplace must now confront.

Our findings reveal that, even in this highly competitive market, investors are committed to pursuing new deals. Many have ambitious plans to build fintech capacity, spurred on by the fear of being left behind. Fintech is the future and the future is now.

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Methodology

In the first half of 2018, Mergermarket surveyed 100 corporate senior executives (CEO, CIO, Director of Strategy) on behalf of Reed Smith.

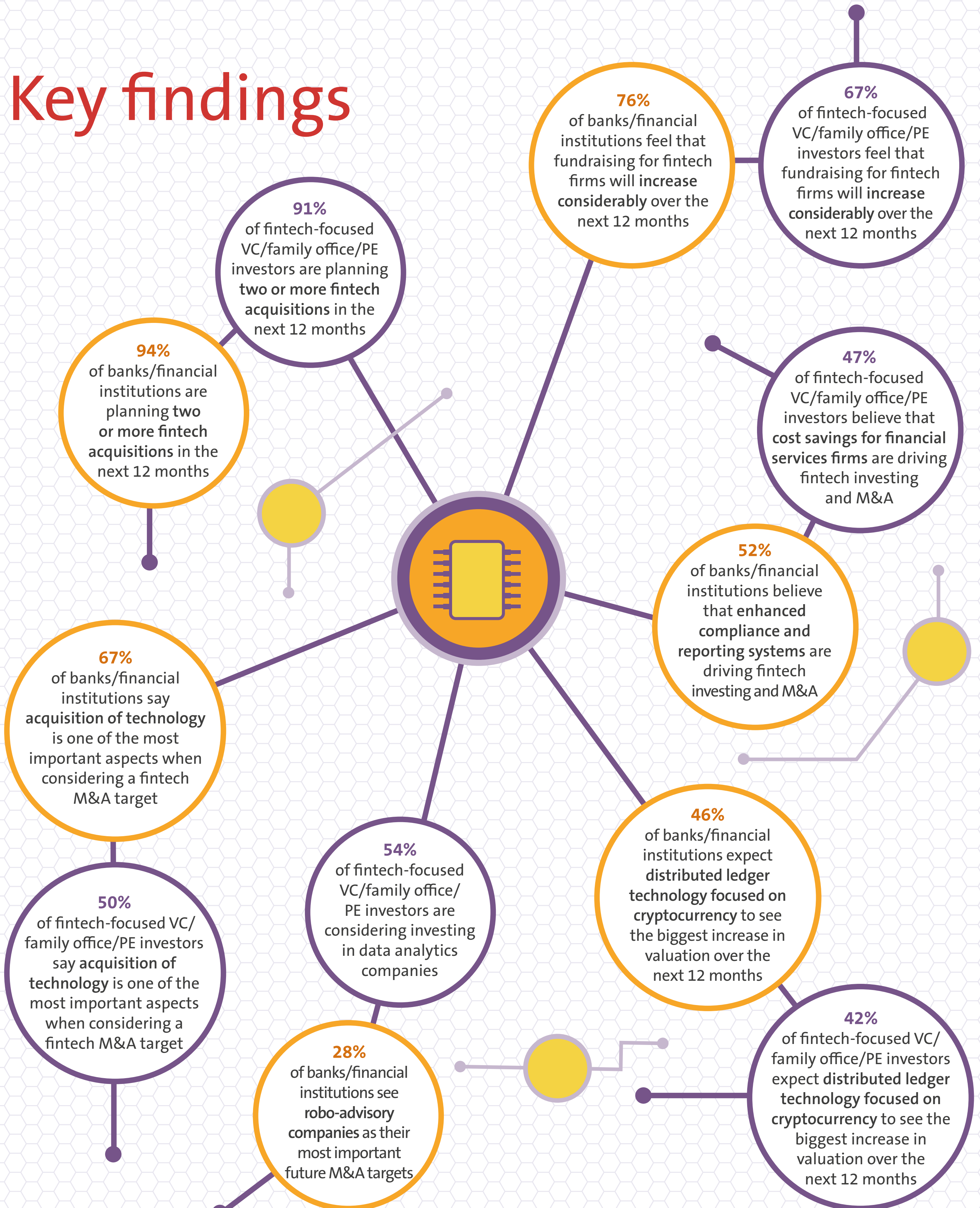
All the companies included in this survey have made a fintech acquisition or investment over the past two years and are considering a fintech acquisition or investment in the next two years. Sixty-seven percent of the respondents were either fintech-focused venture capitals, family offices or private equity investors, and 33% were either banks or financial institutions (intended users of fintech products).

The respondents were split across North America (37%), EMEA (38%) and Asia-Pacific (25%).

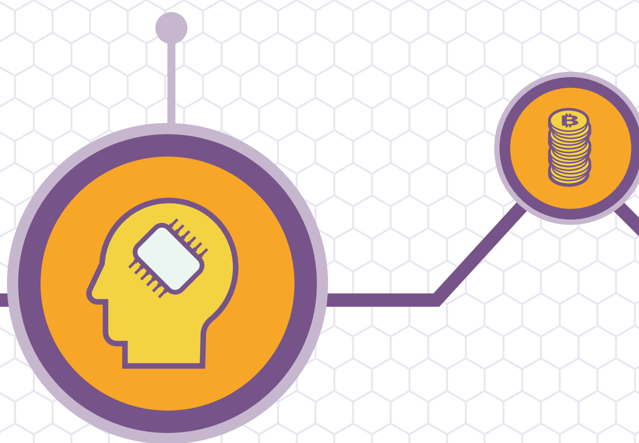
The survey consisted of a combination of qualitative and quantitative questions and all interviews were conducted over the phone by appointment. Results were analysed and collated by Mergermarket and all responses are anonymised and presented in aggregate.

The research is complemented by interviews with Reed Smith's senior practitioners, conducted by Mergermarket.

Key findings



Chapter 1



The fight for fintech

Fintech M&A is at record levels. The competition is fierce as incumbents battle to stay ahead of the curve

Fintech is a phenomenon. Just as with other sectors, the tentacles of technology have coiled their way into the financial services industry and traditional firms are feeling the squeeze. Dealmaking in the sector shows no sign of letting up. Research from the consultancy firm KPMG suggests global fintech M&A during 2017 was up sharply compared with 2016, itself a record year. In total, there were 336 such transactions last year worth a total of $18bn – that compares to 236 transactions worth $11.15bn over the previous 12 months.

These deals spanned a broad range of sub-sectors, including payments, blockchain, banking, lending, insurtech (insurance-based technology) and regtech (regulation-based technology). They also included a series of megadeals, including the largest transaction of all, the $11.6bn purchase by credit card processing company Vantiv of its British rival Worldpay.

Come together financially

Consolidation continues to drive fintech M&A. Large financial services businesses are looking to acquire fintech businesses, both to sustain innovation – particularly in the face of competition from disruptive new entrants to the sector – and to generate synergies, including cost savings that boost the bottom line in a marketplace where pressures on margins remain tough in a low interest-rate environment. In Europe, for example, the second Payment Services Directive and the General Data Protection Regulation (GDPR) implementation are encouraging further competition in banking and related industries from non-financial services business. Mobile-first technologies, improved digital interfaces and better enterprise tools will all remain key priorities. In addition, legacy IT systems offer limited scope for increased efficiency and productivity.

Our research underlines this picture of a buoyant M&A fintech market. Three-quarters of the financial institutions in our survey have made two or more fintech acquisitions or investments over the past two years. Meanwhile, nine out of 10 fintech-focused investors – whether these were family offices, private equity or venture capital – said the same of their dealmaking activity.

Reed Smith on fintech take-up

There isn't a significant financial services institution that isn't already either a consumer or developer of fintech. I think it's on the radar of every major institution because they're at a competitive disadvantage if they're not as well positioned as their competitors to adopt new technologies.

Herb Kozlov, Partner, New York

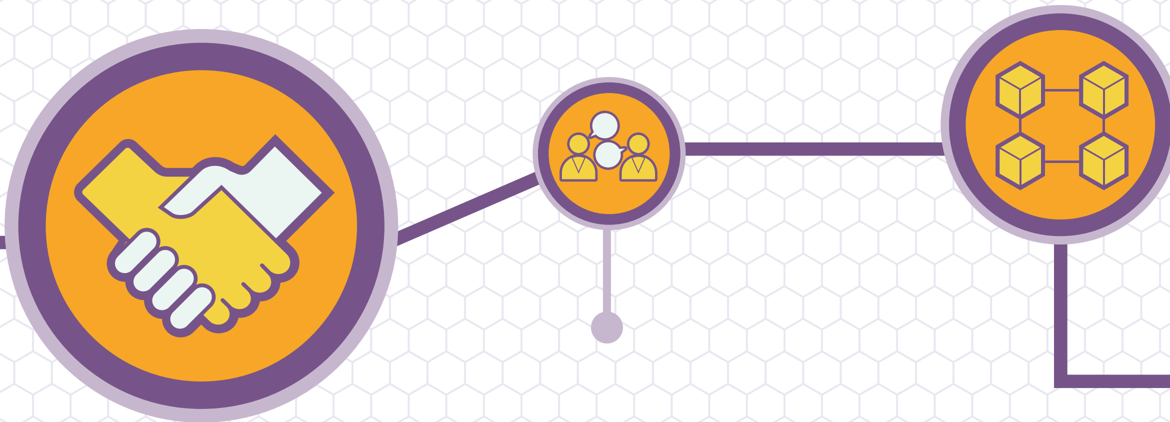
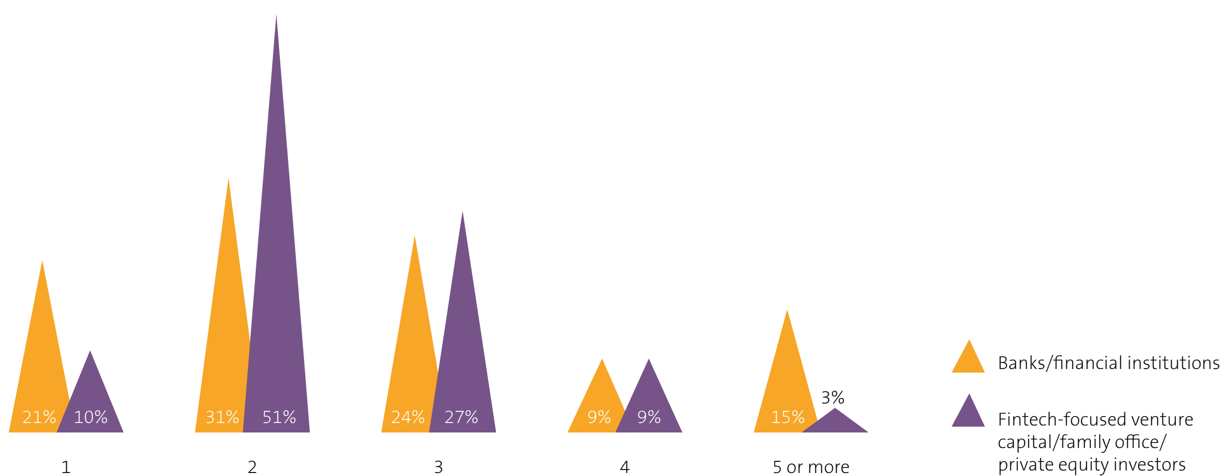
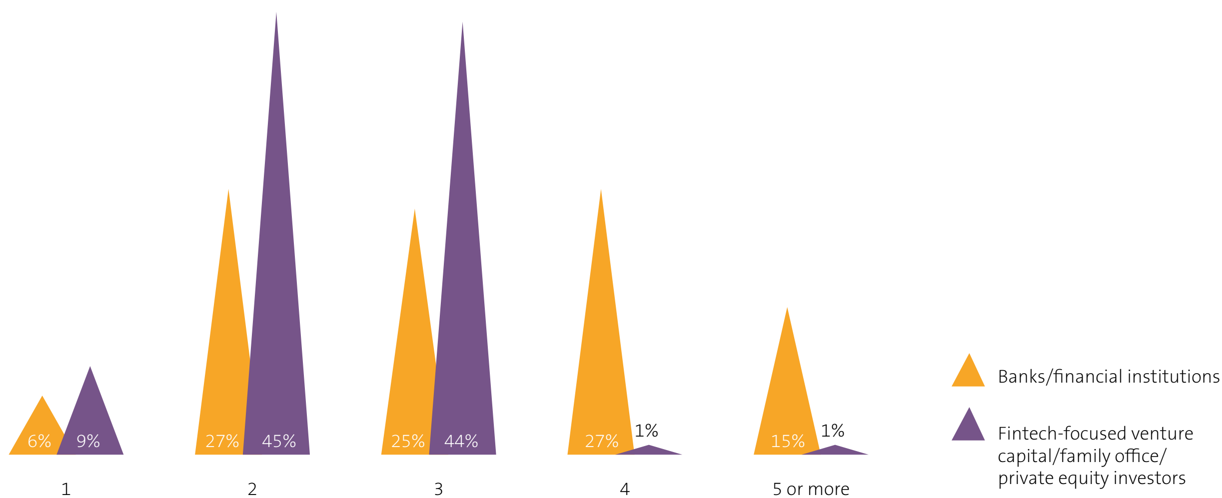


Figure 1: Dealmaking activity, past and future

How many fintech acquisitions/investments have you made over the past two years?



How many fintech acquisitions/investments are you planning to make over the next 12 months?



Looking ahead, more than half the banks and other financial institutions in the research (52%) anticipate making two or three such acquisitions in the next 12 months, while 42% expect to initiate four, five or more deals. Investors are also planning to up the pace of their dealmaking.

“Dealmaking is only going to increase in the future,” says one executive at a leading Canadian venture capital firm. “With so many technological advances in the sector, we must all be prepared to invest to stay in the game.”

Flexing financial muscle

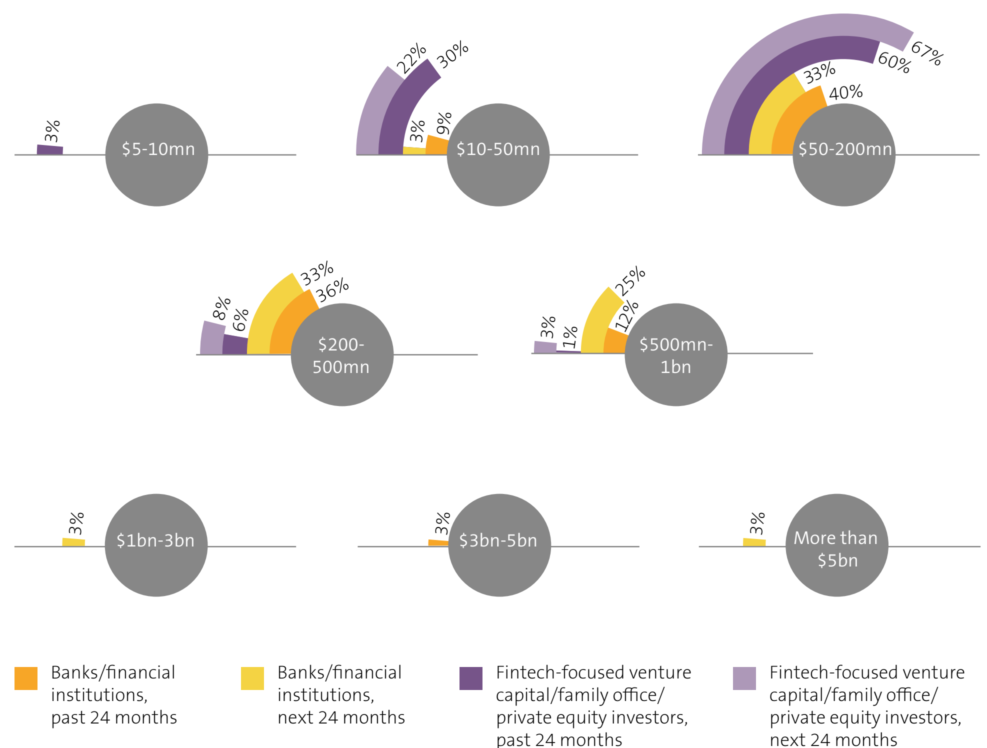
Financial institutions have substantial firepower at their disposal as they survey forthcoming M&A opportunities. Almost a third of these organisations (31%) plan to allocate $500m or more to fintech investment over the next 24 months, more than double the number that allocated such large sums over the past two years. A further third say they are likely to allocate between $200m and $500m.

Private equity, venture capital and family office respondents typically expect to make smaller investments – this is reflective of their relative size – with two-thirds (67%) anticipating allocating between $50m and $200m. However, their appetite for fintech deals also appears to be increasing – more of these respondents anticipate allocating larger sums to fintech investments over the next two years compared to the past 24 months.

Among banks and financial institutions, more than half

Figure 2: Investment set to increase

What level of capital investment have you allocated to fintech in the past 24 months?
And what level of capital investment are you likely to allocate to fintech over the next 24 months?

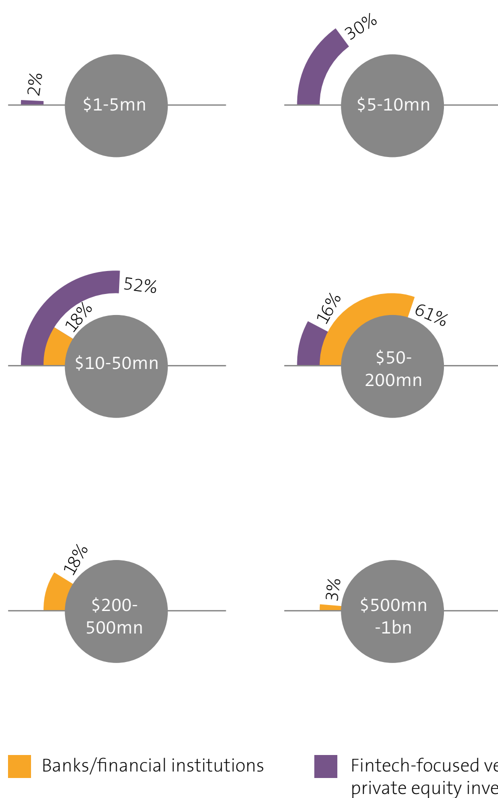


(61%) say they would consider a transaction valued between US$50m and US$200m, while a further 21% would consider even bigger deals. Private equity, venture capital and family office respondents typically are interested in more modestly sized transactions, although 16% say they would consider investments between US$50m and US$200m.

These deals will naturally require careful planning to ensure smooth integration – particularly given the scope for culture clashes between large, traditional financial services and less mature, smaller start-ups, whose informal structures and autonomous working practices may not translate easily into larger institutions.

Nevertheless, fintech dealmaking will continue to transform the financial services industry. “It’s fair to say that there isn’t a significant financial services institution that isn’t already either a consumer or developer of fintech solutions – it’s on the radar of every major financial services institution,” observes Reed Smith partner Herb Kozlov, global co-head of the firm’s fintech practice. “These institutions are consumers of these

What is the maximum size M&A transaction that you would consider?



services, and they're at a disadvantage if they're not as well positioned as their marketplace competitors to adopt new technologies."

"There will be a blurring of the lines, because some of the technologies that are considered fintech, such as distributed ledger tools, are spreading rapidly to other industries, such as data, healthcare, entertainment and media and advertising," adds Reed Smith partner Maria Earley. "Technologies originally developed for financial industry purposes are being adopted and further developed in various other industries, so 'fintech' may eventually be a misnomer."

Reed Smith on areas of adoption

There has been a lot of adoption of machine learning and AI in the investment and payment spaces. I think that payments are really moving to machine learning as well as blockchain. Technologies that are moving forward are then being gobbled up by the bigger institutions.

Maria Earley, Partner, Washington, D.C.

Reed Smith on customers

New ways to reach customers are being developed all the time and banks aren't necessarily considering all of them. Customer outreach could be a higher priority in the sector, but it's not just outreach, it's a matter of providing new customer solutions. I think that this is now starting to become an increasing focus for banks.

Claude Brown, Partner, London

Fintech opportunities

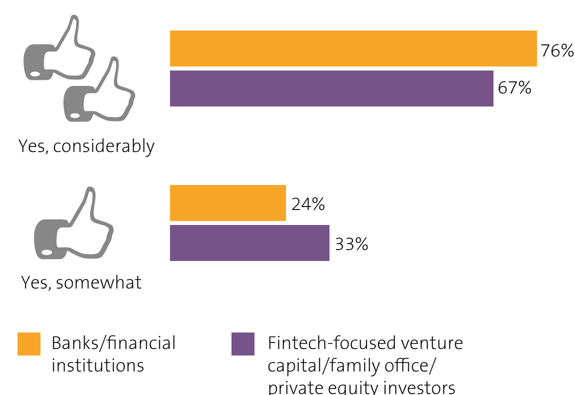
While the imperatives for M&A transactions remain familiar and consistent, our research identifies clear priorities for dealmakers in the months and years ahead. In the following chapter, we explore the sectors, regions and opportunities that will drive fintech deals in the coming year and beyond

Deal drivers

Respondents universally expect fundraising for fintech firms to rise over the next 12 months. Three-quarters of banks (76%) and two-thirds of private equity, venture capital and family office investors (67%) anticipate this rise being considerable. “Fintech is the future and we all have to make our future secure,” says the head of strategy at a German financial institution. “There are so many opportunities to invest in these companies that fundraising activity is bound to increase over the next 12 months.”

Figure 3: Fundraising to increase

Do you think fundraising for fintech firms will increase over the next 12 months?



In practice, there is a broad range of factors driving this increased investment, with motivations varying according to the nature of the businesses involved.

For example, more than half the banks and financial institutions in this survey (52%) suggest fintech investment and M&A are being driven by the need for enhanced compliance and reporting functionality. This is consistent with their intention to invest more in these areas (see page 15) and reflects the regulatory pressures on the sector, as well as new challenges, including the GDPR.

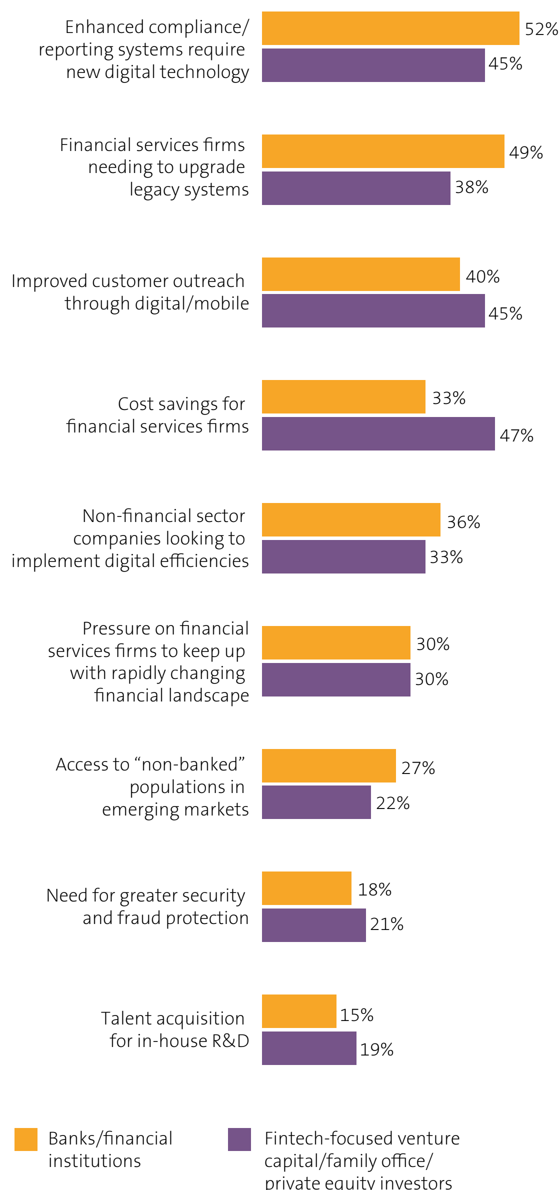
Banks and financial institutions also point in large numbers (49%) to the need to invest in upgrading their legacy IT systems. Acquiring fintech expertise provides a means to evolve IT platforms and infrastructure dynamically, rather than trying to rebuild from within.

Meanwhile, private equity, venture capital and family office investors point to drivers such as the need to improve customer outreach through digital and mobile tools, a factor cited by 45% of respondents. Some 47% of these respondents also point to the need to drive cost savings for financial firms.

A combination of all these factors will apply to dealmakers across the marketplace. Some fintech businesses offer a means to drive top-line growth with better customer-facing technologies or through access to new markets, while others offer the prospect of cost savings, IT renewal or enhanced compliance standards.

Figure 4: Drivers for fintech investment

In your opinion, what is currently driving fintech investing and M&A? (Please select top three)



Driver	Banks/financial institutions	Fintech-focused venture capital/family office/private equity investors
Enhanced compliance/reporting systems require new digital technology	52%	45%
Financial services firms needing to upgrade legacy systems	49%	38%
Improved customer outreach through digital/mobile	40%	45%
Cost savings for financial services firms	33%	47%
Non-financial sector companies looking to implement digital efficiencies	36%	33%
Pressure on financial services firms to keep up with rapidly changing financial landscape	30%	30%
Access to "non-banked" populations in emerging markets	27%	22%
Need for greater security and fraud protection	18%	21%
Talent acquisition for in-house R&D	15%	19%

Reed Smith on fintechs as good sellers

To make yourself more attractive in the fintech space, firms need to have regulatory and compliance expertise. Make sure your product innovation and development meets regulatory needs and requirements, and emphasise your regulatory compliance. When you're looking at the buyers' environment, what they really don't want to do is take on regulatory risk, and they want to make sure everything has been done with their regulation in mind from the beginning. This is sometimes a little bit of a struggle for tech companies, because they are experts at the tech and really underestimate how granular the regulation can get with respect to directing the tech. Having a team that understands the effect of the relevant regulatory regime and has specifically tailored its technology for those relevant regulatory factors will be more appealing to buyers.

Maria Earley, Partner, Washington, D.C.

"It is all about upgrading and trying to keep up with the rapidly changing financial landscape," says the managing partner of a Belgian private equity firm. "Fintech businesses offer the means to do that, in a variety of different ways."

The fintech factor

Equally, different attributes, qualities and features may drive the interest of acquirers and investors in a fintech target. The proprietary technology of the target and its ability to develop technology solutions is certainly likely to be one of those factors: two-thirds of banks and financial institutions (67%) say this aspect is important when considering a potential target. This reflects the need of these buyers to acquire intellectual and human capital and innovative tools and solutions.

Controlling industry access to key technology is seen as the second most important aspect when considering a potential target.

For private equity, venture capital and family office investors, moreover, other factors may apply. For example, almost half (48%) highlight their desire to find fintechs where there is the option of out-licensing products and services, which represents a means to generate value from their investments.

Cross-border criteria

There is also the issue of the jurisdiction in which the fintech is based, particularly for cross-border deals where the investor or acquirer may be taking on a business subject to very different rules and laws from those that apply in its home base. The

Figure 6: Scrutinising the host country in cross-border deals

Which of the following aspects do you believe are most important when considering a cross-border fintech acquisition/investment? (Please select top two)

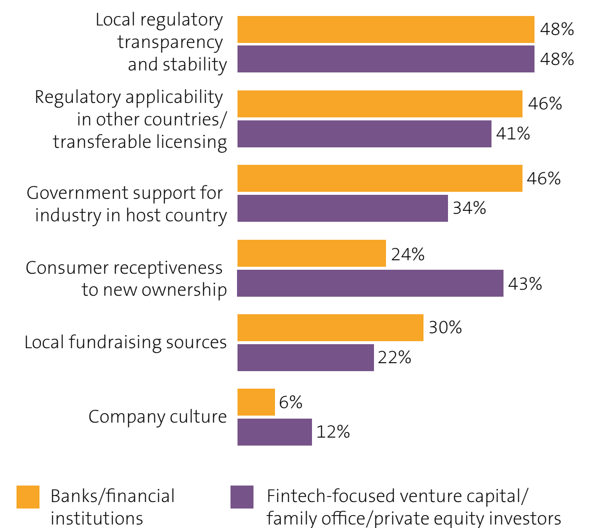


Figure 5: What dealmakers are looking for from fintechs

Which aspects are important to you when considering a potential fintech M&A target? (Please select top three)

biggest factor in such deals, cited by almost half (48%) of respondents, is the need for the country in which the target is based to have regulatory transparency and stability.

Dealmakers are also concerned about issues such as license transferability, government support for fintechs, consumer perceptions and the local fundraising environment.

Fintech attractions

From the fintechs' operating company's perspective, our survey highlights a number of steps that they can take in order to make themselves more attractive; but the most fundamental factor is to be aware of what dealmakers are looking for and to prepare accordingly.

"Fintechs have to work harder to present themselves and the value they offer," says the director of strategy and M&A at a leading Canadian financial institution. "They need to have done that work so they are ready to assist a buyer or investor whenever they are approached."

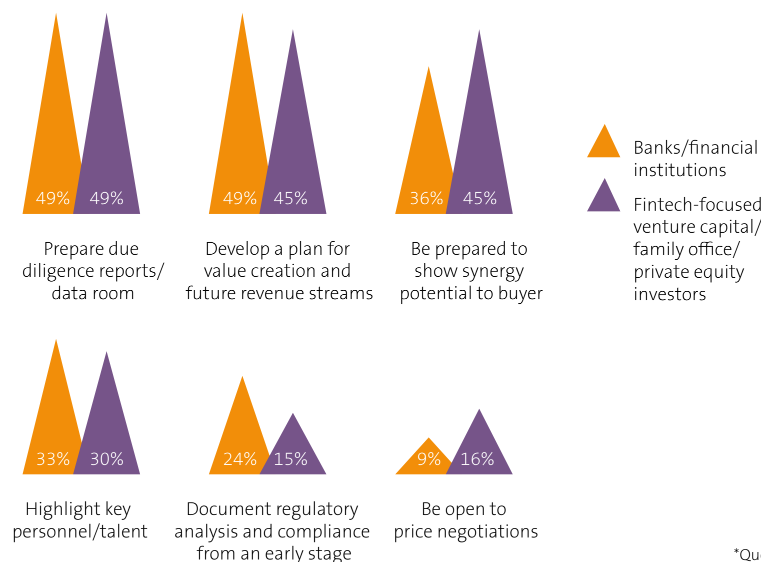
Almost half the respondents in this survey (49%) suggest fintechs prepare due diligence reports and data rooms for prospective buyers and investors – these will ease the way as negotiations begin. Similar numbers suggest fintechs should develop their own plans for value creation and revenue growth – these ideas can then be pitched to those considering a deal. A similar principle applies to making the case for synergy potential.

One-third of banks and financial institutions (33%) and almost as many private equity, venture capital and family office investors (30%) suggest fintechs highlight their key talent. Given that the value of many fintechs lies predominantly in the intellectual capital provided by its innovators, this is important.

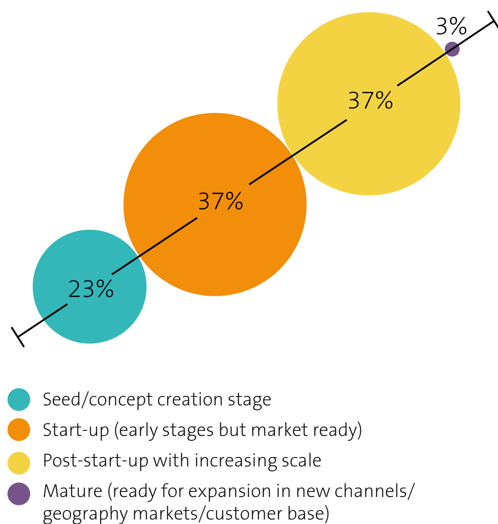
In the end, however, the ability of a fintech to identify potential deal drivers and prepare the groundwork for a transaction – and its willingness to do so – will depend on its resources and the progress of its own development cycle. Acquirers and investors make their investments at different stages – more than half (60%) say they are most likely to consider a deal when the fintech is at seed or start-up stage. At this early point in the company's development, it may not be focused on a transaction or have the resources to undergo the work required to make itself more attractive.

Figure 7: Preparing for a deal

What can start-up fintech companies do to make themselves more attractive to investors and buyers? (Please select top two)



At what stage in a fintech company's development cycle are you most likely to make an investment? (Please select only one)*



*Question asked to fintech-focused venture capital/family office/private equity investors only

Stand-out sectors

The payments sector has been a clear priority area for dealmakers considering fintech transactions over the past two years and that is likely to continue. Around a fifth of banks and financial institutions (21%) and private equity, venture capital and family office respondents (20%) cite payments processing and online payments as the area where they are most likely to target fintech companies for acquisition or investment.

This is a fragmented sector where inefficiencies have been a longstanding issue, so there is an obvious opportunity to make substantial cost savings, particularly with the help of fintech operators that tend to be more mature than in other sub-sectors. The legacy payments infrastructure of some large financial institutions represents an important source of margin improvement.

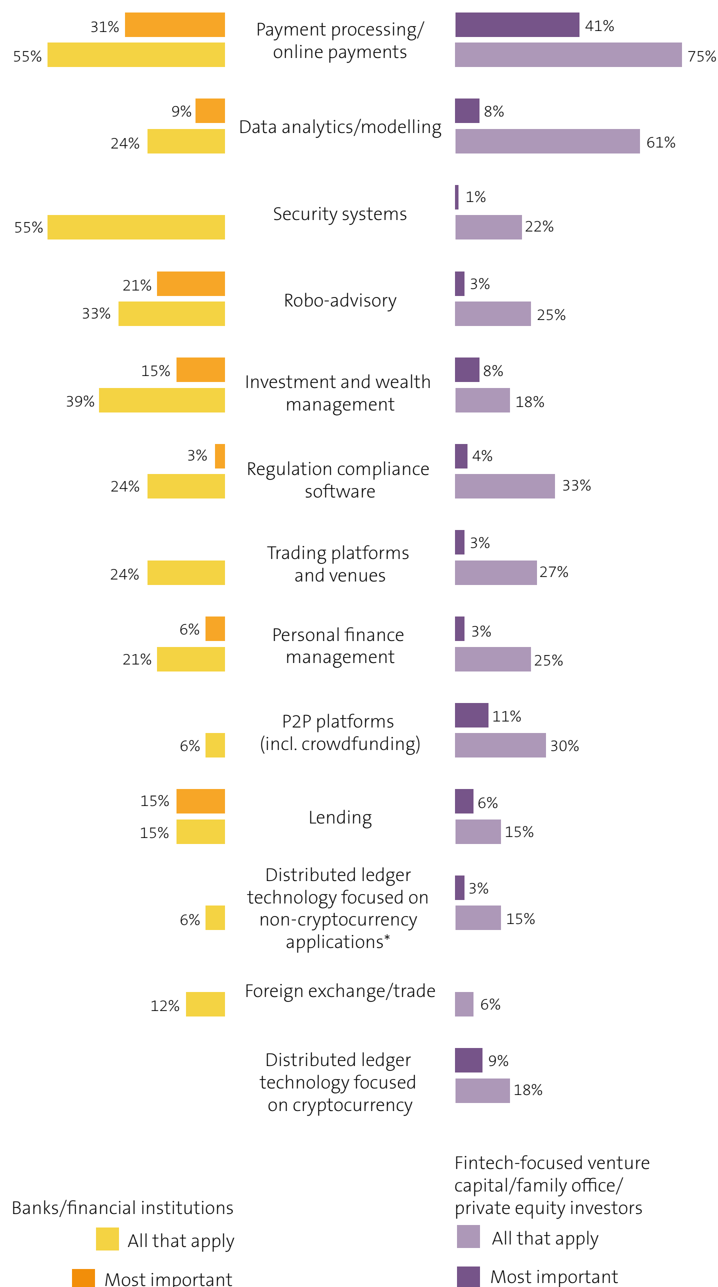
Rules, robots and rapid evolution

However, payments is not the only pressing opportunity for fintech dealmakers. Two-thirds of financial institutions (67%) are considering investments in regulatory compliance software, an even higher proportion than those targeting payments. The extensive regulatory reforms of the past decade have added hugely to the burden faced by financial services firms. Clearly, many businesses see fintech as the solution to tougher regulatory scrutiny.

Almost as many banks and financial services respondents (64%) are considering investments in fintechs focused on robo-advice, artificial intelligence and machine

Figure 8: Where dealmakers have been investing...

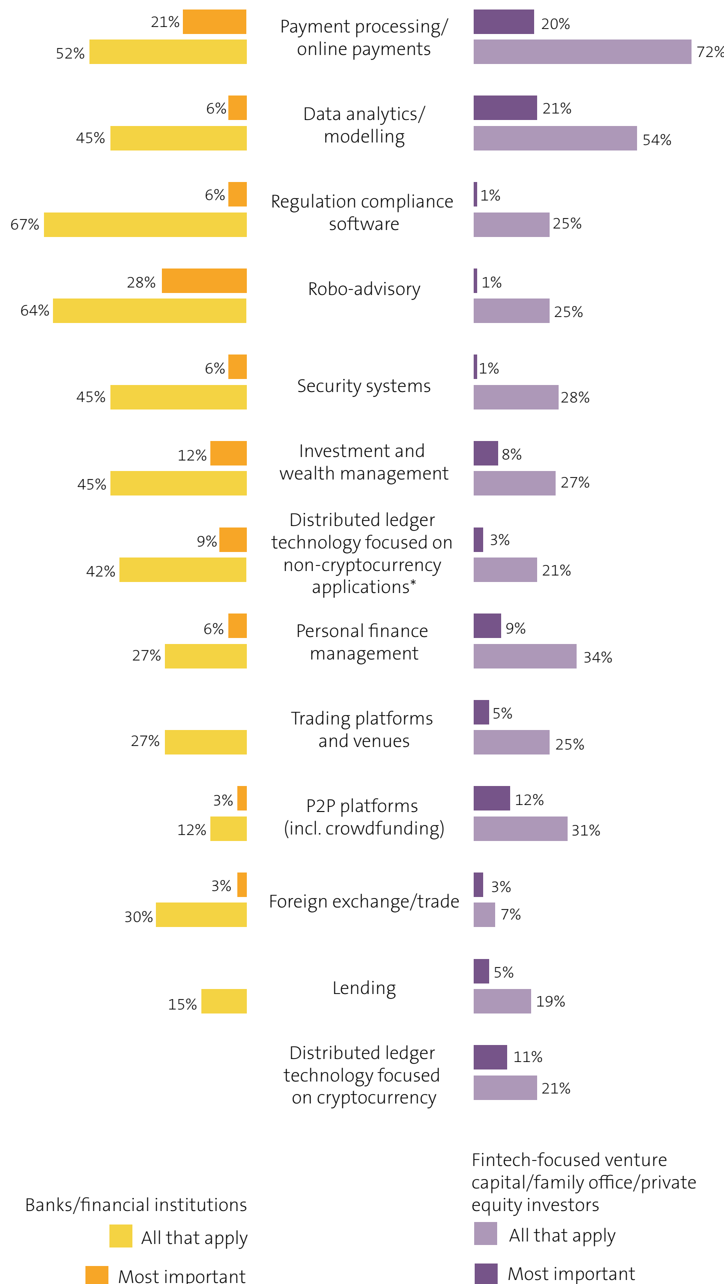
What type of fintech companies did you target?
(Please select all that apply and the most important)



*Including but not limited to exchange transactions, financial instruments, settlement and memorialisation of trades

...and where they intend to invest next

What type of fintech companies are you considering investing in/acquiring? (Please select all that apply and the most important)



*Including but not limited to exchange transactions, financial instruments, settlement and memorialisation of trades

learning. This would give them the opportunity to use technology to create mass market propositions in wealth management, potentially capturing value from a far broader customer base than face-to-face advisers can currently serve.

Meanwhile, more than half (54%) of fintech-focused investors are banking on data and analytics technologies. Rapidly evolving tools in areas such as the collection, storage, safe-keeping, reporting, processing and analysis of data provide exciting new opportunities, both in the front office, where data is the key to improving and personalising the customer experience, and in the back and middle offices, where it offers potential for process improvement and efficiency. A fifth of these respondents (21%) now regard data and analytics as the most important area of fintech for investment or acquisition.

Reed Smith on regulatory compliance and fintech

In the last 10 years, there has been a significant amount of regulatory change. In the US, there's been Dodd-Frank and Volcker that affect banks and financial institutions and exchanges, and in Europe you have MiFID II and EMIR, NIS and GDPR, affecting financial institutions and any company acquiring personal data. It's just so onerous and so personnel-heavy, unless there are tech innovations. That is a real driver for financial institutions to come up with technology solutions for regulatory compliance.

Andreas Splittgerber, Partner, Munich

Overall, though, acquirers and investors should be looking for enduring technologies, argues the managing partner of a Singapore-based venture capital firm. "We are currently investing in various fintech solutions, but our focus is on data analytics and robo-advice," the executive says. "We are looking for technology that will survive in the market for a long time. We see analytics and robo-advisory as having the potential to drive revenues over the next five to seven years."

New kids on the block

As ever, dealmakers' desire to increase their exposure or gain expertise in these areas will be balanced against ever-higher valuations. Respondents anticipate valuation increases in the sectors they see as likely priority targets – notably payments and data analytics, and to a lesser extent regulatory compliance software.

However, it is a different sub-sector, the distributed ledger technology (DLT) underpinning cryptocurrencies such as Bitcoin and Ethereum, that is regarded as the most likely to see a big increase in valuations over the next 12 months. Almost half the financial institutions in the study (46%) cite DLT as an important growth area.

In part, at least, this reflects the feeding frenzy we have seen among cryptocurrency investors over the past year, with prices for leading currencies repeatedly hitting new highs, but also suffering extensive volatility. As the traditional financial services industry seeks to incorporate cryptocurrency into its own practices, processes and services, it may have to pay top dollar for the most attractive targets.

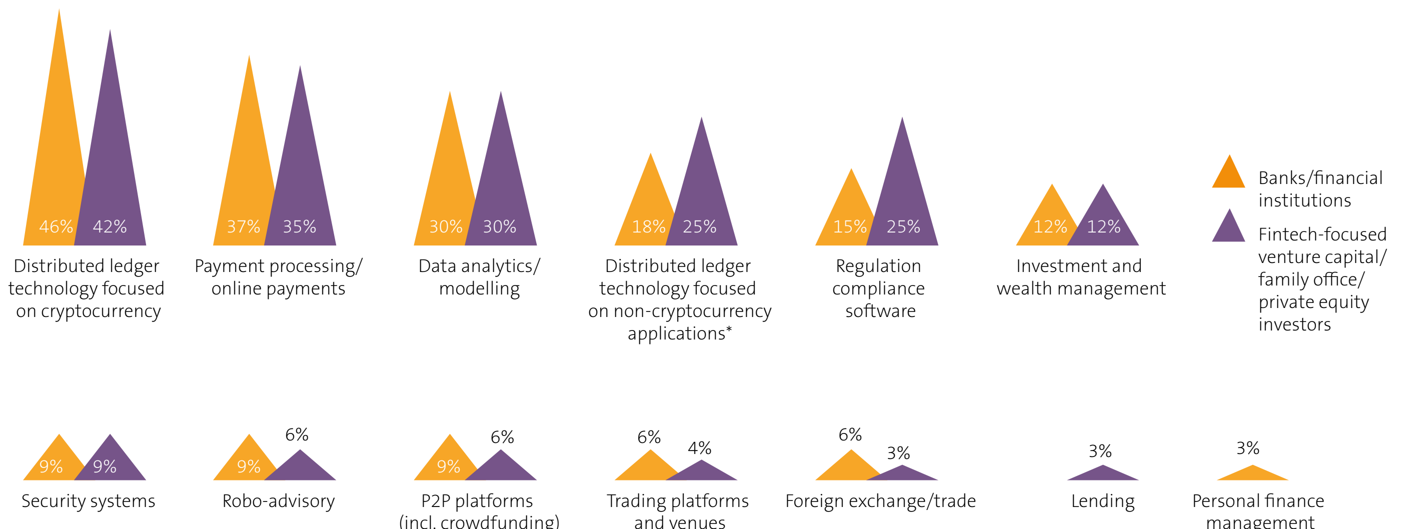
Reed Smith on blockchain

When we talk about blockchain, we're talking about something that is far greater than cryptocurrency. We're at the very beginning of an explosion of new solutions and new outcomes. People are calling blockchain, distributed ledger technology and smart contracts, Internet 2.0. There is an opportunity for dramatic innovation and to change the way businesses function. In the next few years, you'll see explosive growth of the adoption of blockchain technology into the delivery of core financial services.

Herb Kozlov,
Partner,
New York

Figure 9: Where valuations are set to increase

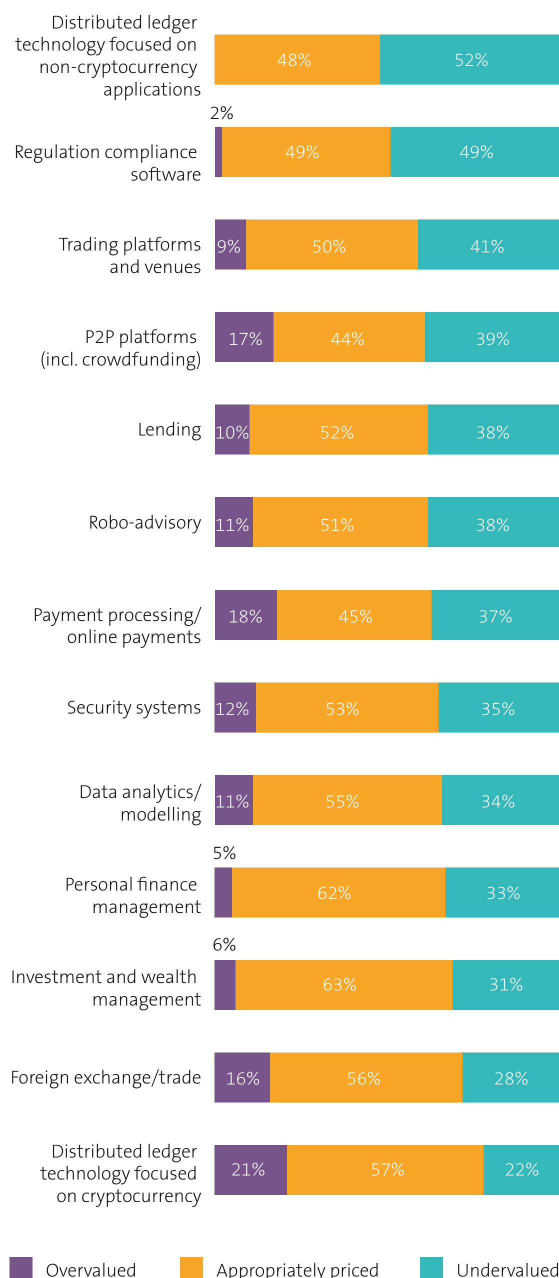
In which sectors do you expect to see the biggest increase in valuations over the next 12 months? (Please select top two)



*Including but not limited to exchange transactions, financial instruments, settlement and memorialisation of trades

Figure 10: Value opportunities?

What is your opinion on current valuations in each of the following sectors?



By contrast, more than half of respondents to this research (52%) identified non-cryptocurrency implementation of DLT applications as the area where fintech targets are most undervalued. This is a potentially interesting opportunity. The application of tools such as blockchain for use cases such as the disintermediation of financial markets and exchanges (such as recording and settling equity and other exchange trades or managing collateral) arguably has far greater potential for the financial services industry than cryptocurrency itself. Today's relatively low valuations may encourage opportunistic dealmakers looking for exposure to this technology.

Similarly, 49% of respondents suggest regulatory compliance software providers are currently undervalued. This is likely to change as more financial services businesses recognise the value of tools with the potential to help them deal more effectively with the regulatory burden – and to provide compliance metrics for measuring performance throughout their organisations.

One other area is worth mentioning: while fewer than one in 10 respondents highlight security systems as an area with potential for fintech valuations to increase, these businesses' tools will be crucial to the whole sector. "With great power comes great responsibility," says the managing director of a US bank. "As businesses generate more data, companies that can genuinely protect that data and boost compliance will become more and more valuable."

Reed Smith on the evolution of the tokenised economy

You will eventually see a bank or large tech company figuring out a token strategy that is regulatory compliant and that will give them an edge. Whether it's a bank that offers the ability to tokenise funds or collateral; an e-commerce lender enhancing the ability to borrow or pay with tokens; or the ability to fractionalise, trade or pay for ownership of assets such as real estate, tokenisation is going to develop quickly, and you're going to see rapid growth in 2019.

Herb Kozlov,
Partner,
New York

Reed Smith on fintech in Europe

Europe has a little bit of the best of both worlds. It has significant financial activity and it also generally has a more industry-friendly regulatory regime – more principles-based than the US. There was support for the crypto space early on from the Bank of England. Germany, similarly, has been very supportive. Munich has been very active in the fintech space, and it's starting to spread now to other EU countries – Estonia and other areas that are big for developers. Other markets, such as Malta and Gibraltar, are seeking to become friendly regulatory environments for the DLT industry in particular. Expect significant regulatory developments over the next 18 months in the region.

Brett Hillis,
Partner,
London

Regions to watch

More than a third of respondents to this survey (39%) say they are most likely to make their next fintech acquisition or investment in Europe, with the region's two largest financial centres, the UK (12%) and Germany (9%), seen as the most likely individual countries. North America is the second most sought-after region.

Developing markets are less likely to see fintech dealmaking, at least in the short term. While the growing middle-class populations of China and India are regarded by Western businesses – including financial services companies – as having huge potential, only 7% and 8% of respondents respectively see themselves making their next fintech investment in these markets. Singapore, a long-established centre for the global financial services sector, particularly in banking and wealth management, is the pick of 6% of respondents.

Times are changing

However, respondents are very aware of the potential of fintech in developing markets. Already, 16% single out China as the country where they see the greatest potential for fintech businesses to gain market share in the financial services sector. This seems rational given the pace at which technology is driving other sectors of the Chinese economy – in retail, for example, China's e-commerce market is considered by some to be the biggest in the world.

Additionally, fintech solutions represent an attractive opportunity for regions such as parts of Africa that are underserved by traditional banking.

As for India, the managing director of a Singapore-based bank points to the skills available in the market. "India has so many talented IT professionals and fintech start-ups," the executive says. "Many of them are looking to partner with big brands all over the world, though it helps if you already have a presence in India because you need to understand local regulation and the legal framework."

Elsewhere, the US is seen by almost half the respondents (44%) as the country where fintech has the greatest potential to take market share. Clearly, the world's largest financial services market is an attractive one for fintech operators, who feel they can break down the traditional barriers and democratise the industry.

In Europe, Germany (the pick of 14% of respondents) is almost three times more likely to be seen as offering potential for fintech companies to take market share than the UK (5%). This could well be due to the uncertainties around Brexit (for more, see The Brexit influence, page 22).

The next big thing

The race is on among cities around the world to attract fintech businesses and take on the centres of excellence in Silicon Valley. Investors and acquirers certainly see opportunities in this regard. "Our fund started by targeting investments in West Coast US, but we have moved on to New York and into European cities such as Berlin," says the managing partner of a Japanese venture capital investor. "We plan to gradually expand around the globe."

Figure 11: Regional targets for fintech investment and acquisitions

In which region are you most likely to make your next fintech acquisition/investment?
(Please select the most important)

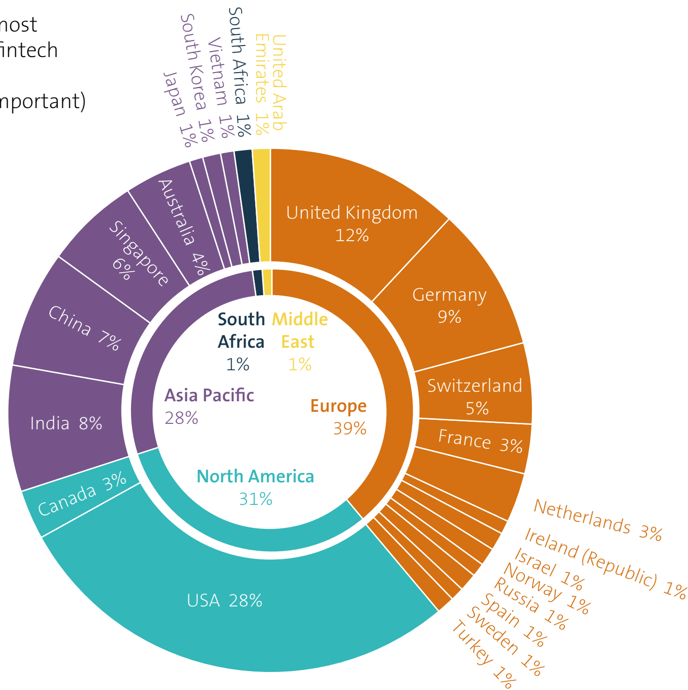


Figure 12: Where fintech potential to take market share is greatest

Which region do you think has the most potential for fintech to gain market share in the financial services sector? And in this region, specify the country where fintech is most likely to be adapted by the financial services sector.

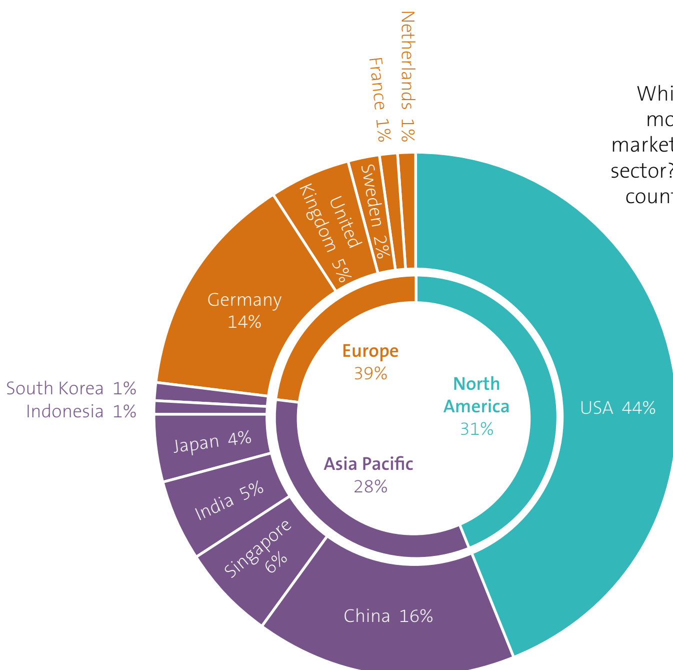
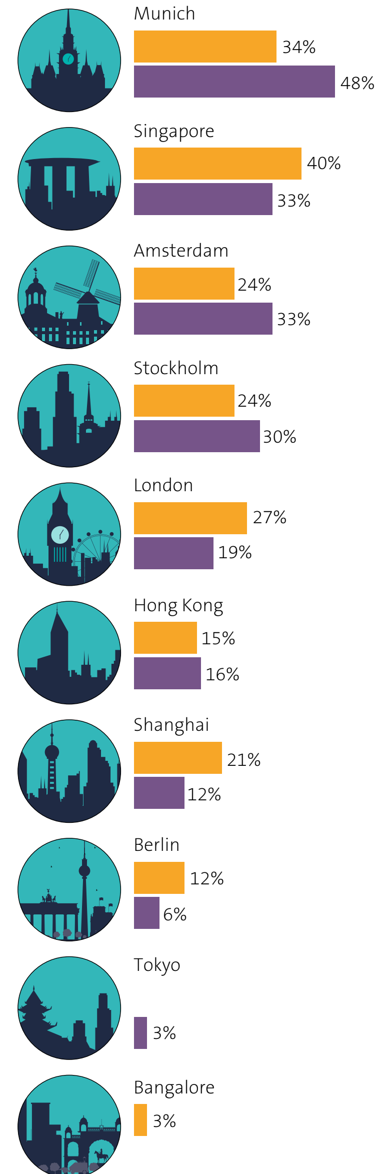


Figure 13: The next fintech hubs

Which cities do you think are most likely to be coined as a global fintech hub over the next two years?
(apart from Bay Area/Silicon Valley)
(Please select top two)



Our respondents expect the race to be close. Among banks and financial institutions, 40% pick Singapore as likely to rise to global prominence as a fintech hub over the next two years, while 34% pick Munich. Private equity, venture capital and family office respondents also choose these two cities, but in reverse order, with 48% going for Munich and 33% singling out Singapore. Alternative choices, including Amsterdam, Stockholm and London, also attract notable numbers of recommendations.

Both Munich and Singapore have certain advantages over their rivals, particularly their status as significant financial services aside from fintech. Both have also invested in local initiatives designed to attract fintechs – for example, with regulatory support in Singapore and municipal assistance in Munich, which is also benefiting from the rising cost of rents in Berlin, which has previously attracted many start-up businesses.

Nevertheless, these cities will not have an easy ride. London, in particular, continues to fight to retain a prominent role – not least with the efforts of the Financial Conduct Authority (FCA) to provide a regulatory sandbox in which fintechs can experiment with new solutions. Amsterdam, meanwhile, hopes to be a beneficiary of Brexit in a broader financial services context, including fintech, while Stockholm's attractions include high standards of living and a supportive ecosystem for start-up enterprises.

Reed Smith on the strengths of Munich and Singapore

They both have several local supportive issues. Munich has a significant financial sector and has been offering office space and other incentives. They are designing it to attract start-up companies. With Singapore, it's similar. The jurisdiction has made becoming a fintech hub a priority, and the monetary authority has attempted to be supportive with sandbox initiatives and some regulatory guidance, without being overly restrictive.

Matthew Gorman, Partner, Singapore

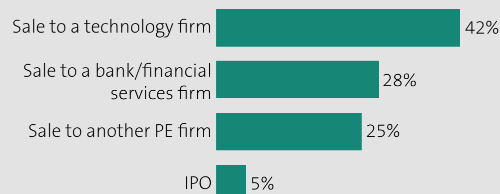
Zooming in on exits

Among the private equity, venture capital and family office investors in this survey, 42% see the sale of a business to a technology firm as their most likely future exit route. This underlines the extent to which fintech is not a space that financial services businesses can expect to have to themselves. In fact, barely more than a quarter of these respondents (28%) envisage selling to a bank or another financial institution. Almost as many (25%) regard another private equity buyer as providing them with a potential exit in the future.

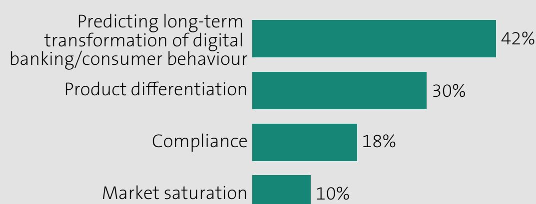
Equally, many respondents accept that investing in early-stage and immature fintechs and then securing value further down the road is an exercise that is fraught with uncertainties. Some 42% say the biggest challenge is anticipating what the market will look like when the time comes to sell. It is very difficult to predict how digital banking transformation will pan out, or how consumer behaviours will change. Meanwhile, a further 30% worry about how they will differentiate the products and services of portfolio companies. Compliance is a headache for 18% – regulatory change could prevent some fintechs reaching their full potential.

Figure 14: Preparing for an exit

What is your most likely exit strategy? (Please select one)*



What is the greatest challenge for preparing an exit? (Please select only the most important)*



*Question asked to fintech-focused venture capital/family office/private equity investors only

Spotlight on initial coin offerings

In an initial coin offering (ICO), enterprises raising money issue “coins”, or digital tokens, to their investors rather than traditional securities. These coins may be issued by the enterprise specifically for the purpose of fundraising – investors hope their tokens will rise in value if the enterprise is successful, similar to traditional securities, or may be issued as part of the functionality of a new platform or protocol. In many jurisdictions, ICOs may be regulated as securities offerings, depending upon the characteristics of the ICO and the token.

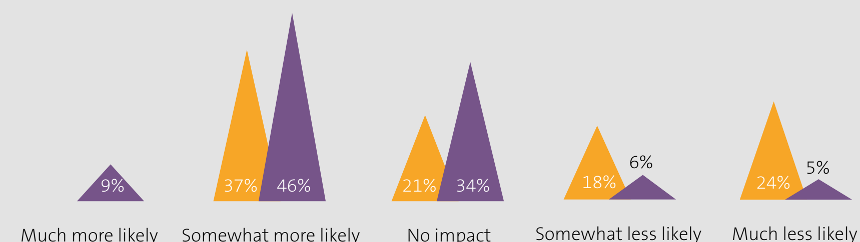
From an issuer’s perspective, an ICO aligns the interests of the investor with the company they’re backing: use of the token will ideally drive activity on the company’s product as well.

Despite concerns about a bubble in the ICO market, investors and acquirers considering these businesses may take some comfort from the fact that early backers have bought into the company’s value story.

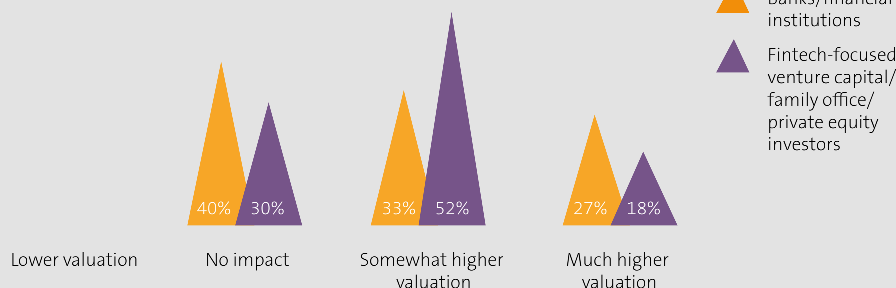
In our survey, 55% of private equity, venture capital and family office investors say they would be more likely to invest in a fintech firm that has carried out an ICO, though this falls to 37% among banks and financial institutions.

Figure 15: Perceptions of ICOs

Would you be more or less likely to acquire a fintech firm if it has carried out an Initial Coin Offering (ICO)?



How would having conducted an ICO impact your valuation?



By contrast, 60% of banks and financial institutions say that they would value a company that has conducted an ICO more highly, and 70% of private equity, venture capital and family office investors agree. The jury is out, however – significant numbers of these respondents also say an ICO would make no difference to their likelihood to invest and the valuation they afford a business.

The Brexit influence

The UK's departure from the European Union in May 2019 might be expected to have a major impact on Europe's fintech markets. There has been a great deal of speculation that London, Europe's largest financial centre, will lose ground to rivals in Germany, France and the Netherlands.

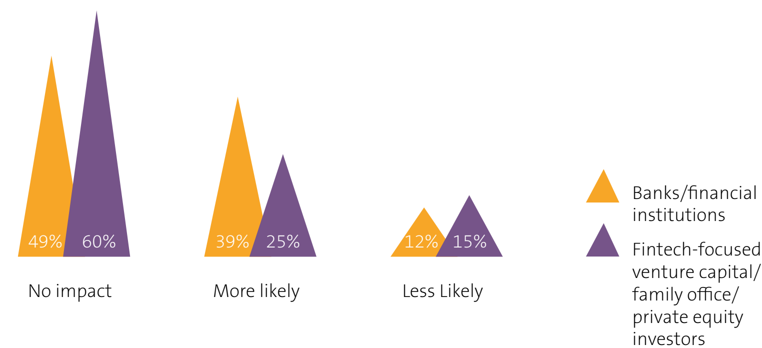
However, the majority of respondents do not see Brexit as a major factor in their UK investment decisions. Around half the banks and financial institutions in the survey (49%) say Brexit will have no impact on the likelihood of them considering UK acquisitions or investments. This rises to 60% among private equity, venture capital and family office respondents.

Among respondents who do anticipate an impact, the more common expectation is for Brexit to make it more likely that they will target the UK for fintech acquisitions – 39% of banks and financial institutions take this view, for example, against only 12% who say they will be less likely.

There are a variety of potential explanations for these findings. One is opportunism: the decline in the value of sterling since Brexit has made acquisitions and investments in the UK cheaper for many overseas buyers. Another possibility is that would-be acquirers of UK fintech firms see this as an attractive means of maintaining their exposure to the UK – possibly even to ensure continued access to the UK market as financial services regulation changes in the wake of Brexit.

Figure 16: The impact of Brexit on dealmakers

Are you more or less likely to consider a UK target as a result of uncertainty surrounding Brexit?



It is also the case that the UK's fintech sector is widely admired and has attracted some outstanding talent in recent years. The supportive regulatory environment; English as a common language; and the attractions of the UK's capital city culturally have all combined to make London an important fintech hub. In this context, it makes sense that investors in fintechs say they want to continue to target the UK.

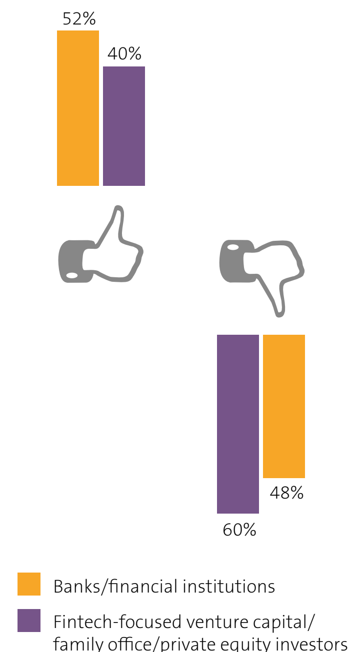
The partner of an American venture capital firm puts it succinctly: "There is uncertainty in the UK for now, but that will stabilise," he says. "Investors that neglect the UK now will regret it, given its capacity to bounce back based on its geographic location, reputation and the availability of talent in almost every field – we are not taking that risk."

Fight or flight

Nevertheless, our survey reveals mixed views on fintech firms' potential flight from the UK following Brexit. A small majority of banks and financial institutions

Figure 17: Should I stay or should I go?

Do you think Brexit will result in a flight of fintech start-ups to other European countries?



(52%) envisage a departure of fintech start-ups to other European countries once the UK has left the EU. However, this figure falls to 40% in the case of private equity, venture capital and family office respondents.

"The number of fintech start-ups in the UK will take a hit post-Brexit," argues the head of investment at a South African bank. "The UK has been a great market generator for Europe but after Brexit, at least in the short term, the UK will become more focused on its own economy."

Much will depend on the final shape of the agreement under which the UK leaves – assuming that a deal can be reached. For fintechs, a number of concerns are paramount. Freedom of movement is certainly an issue – fintechs recruit from an international pool of talent so reforms that limit their access to this pool would be a problem. Access to EU markets from the UK is also a consideration: there is no guarantee that the passporting regime under which UK-based businesses can currently sell financial services and products to customers in other European Union member countries will continue.

On the other hand, there are good reasons to remain confident. Few analysts expect the UK's financial services industry to lose significant market share under Brexit – providing fintechs with every reason to stay in the UK – while a deal that solves the passporting issue is important for the EU as well as the UK. As for freedom of movement, fintechs look globally for talent – while they may find it harder to employ people from the EU, it might become easier to recruit from Asia and North America in the future.

Nor is there any reason to expect the UK's fintech-friendly regulation to be tightened after Brexit – if anything, regulators will work harder to provide support. Finally, the UK is likely to remain an important centre of capital funding for growing fintechs.

In this context, many analysts are sanguine. Research carried out by consultant PwC, for example, points out that nine of the 20 largest ever fintech deals in the UK completed after the UK voted to leave the EU.

Reed Smith on the UK fintech landscape

The fintech market in the UK is very strong. Indeed, Europe is still being driven by London. A recent report from KPMG showed that in the first half of the year, the UK, and London in particular, attracted the lion's share of global fintech funding – US$16.1bn out of US$57.9. So, while Brexit may have some impact, the UK fintech sector should remain buoyant.

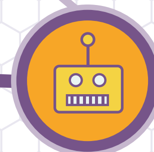
Herb Kozlov,
Partner,
New York

Reed Smith on the post-Brexit fintech landscape

I think one of the outcomes will be more of a distributed fintech community in Europe. Brexit won't shut things down in London, but it does create an open door in other communities. The stated strategy of UK regulators is not to stifle innovation in fintech but to understand the risks and issues involved to create opportunities and manage the challenges. This regulatory environment will continue to improve operational resilience in fintech solutions, add transparency and create more efficiencies and encourage greater investment in the sector. I don't think this approach will alter with Brexit and as a consequence I don't think Brexit will hurt fintech in the UK.

James Wilkinson,
Partner,
London

Chapter 3



Fintech challenges

While the opportunities in fintech abound, there are obstacles both in the dealmaking process and in the subsequent integration. In this chapter, we explore the issues that dealmakers face from a technology landscape that is ever changing

Acquiring and integrating a fintech business requires an understanding of the target company's value proposition at a granular level as well as possibly securing regulatory approval for the transaction. Moreover, getting the deal done is only the first step. Acquirers and investors must implement a successful integration plan.

For these reasons, board-level executives can be wary of fintech transactions, says the head of investment at a South African bank. "It can be an uphill task to present the idea of acquiring a fintech business to the board," the executive warns. "Support is hard-earned and the case for a return on investment has to be strong."

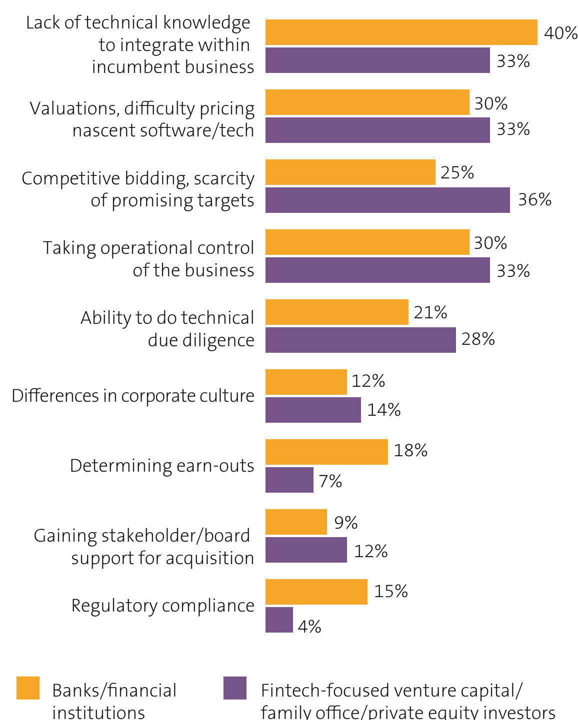
In practice, the respondents in our survey cite a broad range of challenges. The most common concern for banks and financial institutions (cited by 40%) is that they may not have the technical knowledge to successfully integrate with the business they are acquiring. It is vital that they address this issue before committing to the deal – for example, by building up talent in areas where they are lacking skills and experience. The skillsets available in the target business, including broad integrational expertise as well as specialist technical knowledge, may also be important here.

As for private equity, venture capital and family offices, their most common challenge, cited by more than a third of respondents, is the competition for targets and the scarcity of promising businesses. This was only a concern for 25% of banks and financial institutions – possibly because they have deeper pockets, or because they are targeting fintechs of different scale and size.

One other issue highlighted by all respondents is the potential difficulty of conducting technical due diligence on targets. Resolving this problem will be essential, given that so many fintech

Figure 18: Deal concerns

What are the greatest challenges you face when acquiring /investing in fintech companies? (Please select top two)



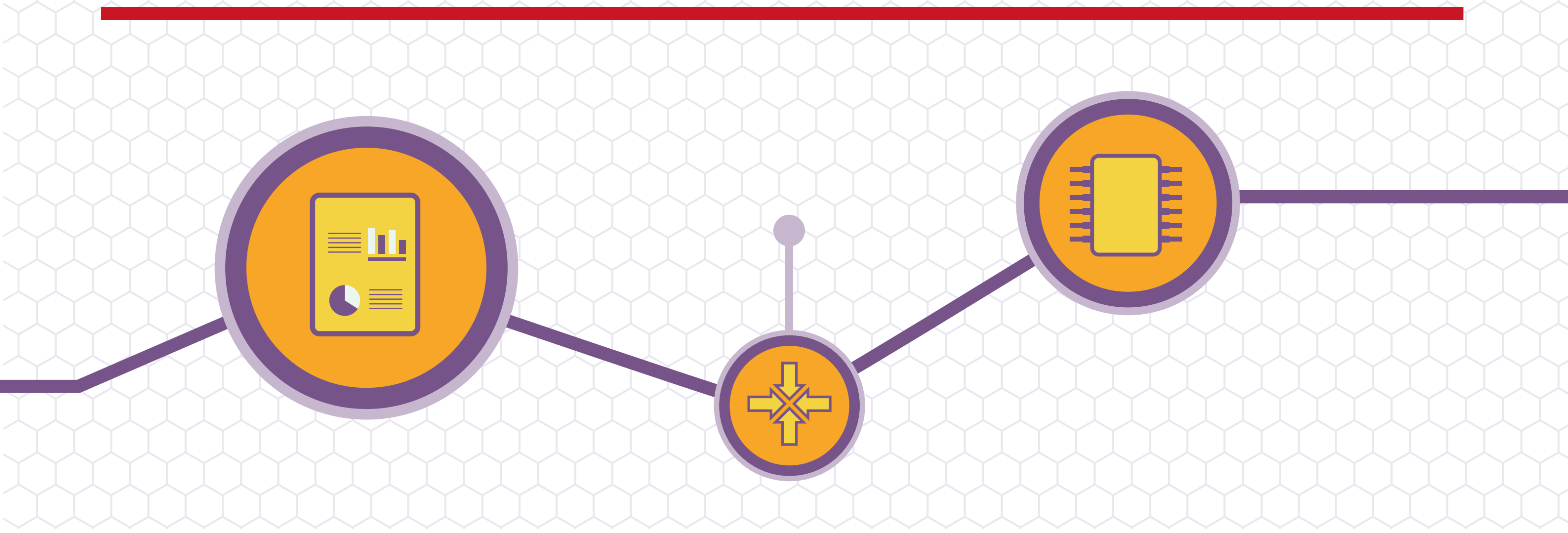
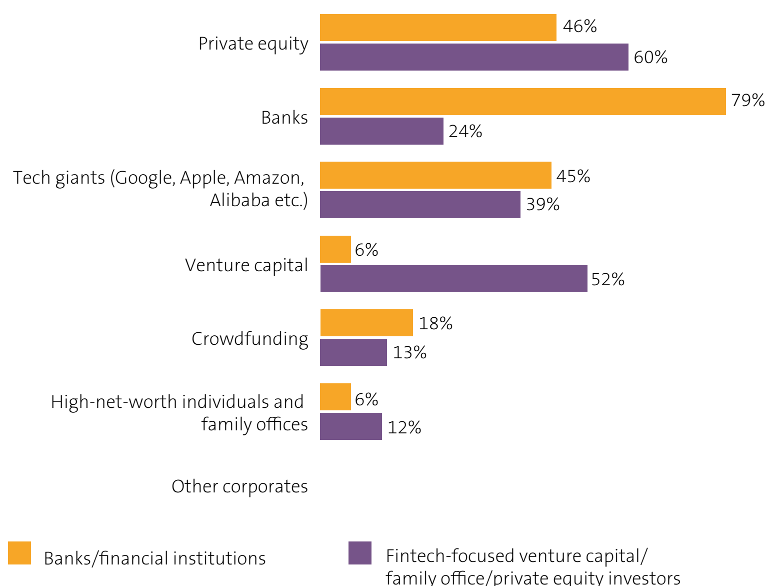


Figure 19: Tough competition for the best deals

Which of these do you consider to be the most competitive buyers and investors in the fintech space? (Please select top two)



Reed Smith on integration

Acquisition opportunities may be squandered in the absence of a successful integration plan. The most successful acquirers begin their implementation plan well before the deal closes, aligning staff and technology. This is especially important in the acquisition of sophisticated technology in a highly regulated industry.

James Wilkinson, Partner, London

transactions are predicated on the desire to acquire or integrate the technology of the target business.

Rival bidders

On competition, the battle to partner with the best fintech targets is bound to be a tough one, given the long-term value potential these businesses offer, as well as the ongoing imperative in the financial services sector to embrace digital transformation. However, our research suggests competition is fierce for another reason too: there is a wide range of rivals potentially fighting it out for each target.

More than three-quarters (79%) of banks and other financial institutions regard one another as their biggest source of competition for fintech acquisitions and investments. Significantly, however, these respondents are also likely to expect competition from beyond the financial services sector: almost half (45%) regard the giant technology companies as potential rival bidders.

Private equity, venture capital and family offices are more likely to see their peers as the competition. Here too though, significant numbers are eyeing rivals outside

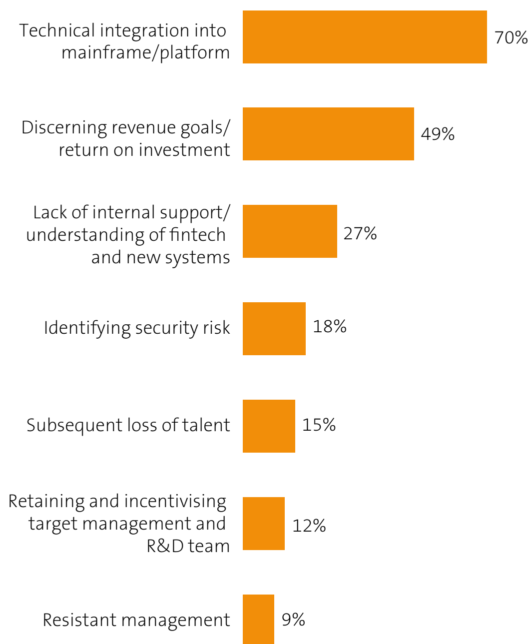
Reed Smith on "hit and hope" acquisitions

Not every M&A transaction really succeeds, but the sophisticated acquirers know that, and they look at it differently. They might acquire five technologies knowing full well that one or two of them are going to drop out, but the only way to find out if it works is to own it and kick the tyres as the owner, as opposed to a consumer or customer. As part of the business strategy, if a financial services institution makes one technology acquisition, it has to get it right. If it's making five, it doesn't have to get all five right. It's an expensive test drive.

Herb Kozlov,
Partner,
New York

Figure 20: Focusing on integration challenges

What are the greatest post-merger integration challenges you face when acquiring fintech companies? (Please select top two)*



*Question asked to banks/financial institutions only

of financial services, with 39% picking out the big technology companies as likely competitors in a transaction.

"Fintech acquisitions are on the agenda of most financial and technology companies this year," says the managing partner of an Australian venture capital firm. "It is going to be tough to acquire your desired targets given this competition, particularly at a fair valuation."

Once the competition has been seen off, the hard work of integration and value creation begins. Acquirers need to create a clear plan for technical, financial and operation integration before completion, with the help of third-party advisers if need be.

"All acquisitions carry significant risks and identifying the most critical of those risks can be difficult," says the director of corporate development at a US financial institution. "You can't force-fit something but that means you have to take time to let the business settle down – and that can be difficult to manage in a fast-moving market."

More than two-thirds of financial institutions (70%) worry about their ability to integrate new technologies into their existing mainframe or platform, suggesting that pre-deal work needs to centre on how to marry legacy IT infrastructure with the tools and solutions being acquired.

Similarly, almost half of financial institutions (49%) in this research regard discerning revenue goals and returns on investment as one of their greatest post-merger

integration challenges. Again, the key to addressing this issue lies in pre-deal planning. Acquirers and investors need to set clear targets for post-deal performance and build measurement structures that provide visibility and transparency about how those targets are being met.

The final piece of the jigsaw will often be in bringing the new technology or solution to market. This will require investors and acquirers to meet a range of challenges. More than half worry about building customer acceptance for new products and services, while banks and other financial institutions in particular worry about the coherence of the international regulatory frameworks in which they must operate. Private equity, venture capital and family office investors are more likely to worry about domestic regulation, perhaps reflecting the smaller transactions in which they tend to specialise.

Figure 21: Bringing new fintech to market

What is the greatest challenge when bringing new fintech to market? (Please select top two)

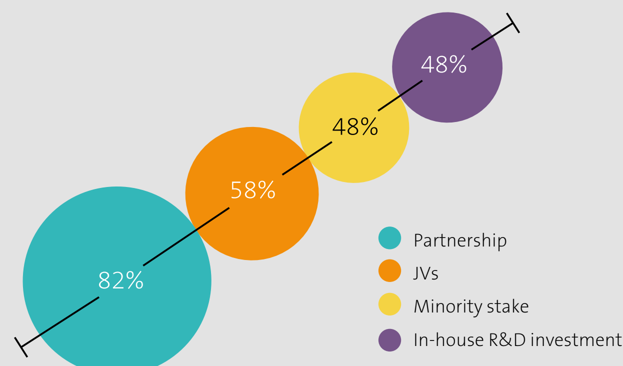
Alternatives to M&A

Conventional M&A activity is far from the only way to build fintech exposure. Many in the marketplace are building a range of different relationships with fintech businesses.

More than three-quarters (82%) of respondents point to partnerships as an alternative to M&A for developing fintech capacity, while more than half (58%) have considered joint ventures. Almost half (48%) look at taking minority stakes, while the same number are prepared to consider in-house R&D.

Figure 22: Building fintech capacity

Which other routes to develop fintech capacity have you considered instead of M&A? (Please select all that apply)*



*Question asked to banks/financial institutions only

Conclusion

It is clear from our research that fintech investment is set to remain buoyant – investors and acquirers of all shapes and sizes express a desire for greater fintech exposure and capacity across a broad range of sectors and regions

While there will naturally be ebbs and flows in relative levels of demand, as new technologies emerge and evolve and regional factors come into play, overall appetite for fintechs will only increase.

Nevertheless, acquirers and investors need to be strategic as they target fintechs that represent a good fit for their own business. "Too many acquisitions are wasted – a lot of companies acquire something they may not fully understand and are unable to properly implement," warns Reed Smith's Maria Earley. "It's not as easy as simply taking a system and replacing it, and integration is often costlier and more complicated than anticipated."

Reed Smith's Herb Kozlov also urges acquirers and investors to be circumspect. "Successful deals share two common traits," he says. "First, integration does not start the day the deal is complete – it's something you're considering and exploring at every stage of the transaction. Second, human capital is crucial, because that's a crucial part of what you're buying with the technology – everyone's interests need to be aligned."

In these contexts, our research provides some key takeaways for both would-be investors and fintechs to consider:

1 **Don't follow the flock.** The payments sector is a clear priority for many investors in fintechs, but other sub-sectors will see plenty of action too. Don't just look at the "next big thing". It is imperative to align targets with the business imperatives facing the organisation, identifying solutions and skills that an acquisition could provide.

2 **Broaden your horizons.** While deal activity is expected to increase around the globe, competition is expected to be hottest in Europe over the next 12 months, followed by North America. But investors and acquirers should not overlook the potential of fintechs in developing markets.

5 **Stay open-minded about fintech targets.** Deal drivers for fintech acquisitions and investments vary according to the target company, but it will be important to remain open-minded and imaginative about M&A strategy. While some fintechs offer exciting opportunities to drive top-line growth, others will offer benefits such as cost synergies, operational efficiency and improved regulatory performance. For example, digital ledger technology companies may provide innovative compliance cost reductions and efficiencies.

6 **Do your diligence.** Acquirers and investors must prepare carefully for a deal. They may need to invest in resources that provide them with the means to make more accurate technical assessments of targets' technology and to integrate those technologies once the deal completes.

3 Hunt for bargains. Valuations vary in part according to what is fashionable, but this can create opportunities too. For example, while valuations of fintechs involved in distributed ledger technologies related to cryptocurrencies have soared as interest in this area has mushroomed, the broader applications of this technology may ultimately be more valuable; yet fintechs engaged in this work are currently priced more cheaply.

4 Don't be put off by Brexit. The UK's secession from the EU will undoubtedly create uncertainties for investment but most respondents believe it would be a mistake to neglect this market given its long-term attractions.

7 Study the competition. Dealmakers will need to be ready to move quickly, and to recognise that rival bids may come from unexpected sources, including businesses outside of the traditional financial services sector.

8 An early integration plan is imperative. Deals are unlikely to be successful in the long term without a clear plan for integration – would-be investors and acquirers must begin work on integration planning well before completion.

9 M&A is not the only transaction. Collaborations including partnerships, joint ventures and funding support for fintech start-ups may also produce good results; nor should in-house R&D be neglected.

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