

Financial Technology M&A in 2006

Focus on banking, securities and investment markets

‘Valuations are high’ and ‘there has rarely been a better time to sell’ are comments that we have been hearing regularly from the market during the first half of 2006. Whether these are true statements or not remains to be seen, but certainly the valuations of public companies across the sector and the number of transactions completed seem to support these comments, with around 220 financial technology deals announced in the first half of the current year, compared to about 180 in the first half of 2005.

Our market predictions for 2006 have largely been borne out thus far, with regulatory risk and compliance issues remaining centre stage with hedge funds in general and the increasing usage of derivatives and other complex instruments by the wider market a close second.

From an M&A perspective, smaller financial technology suppliers are finding it harder than ever to grow in the presence of larger competitors and we are increasingly seeing commonality in growth constraints applied to these smaller suppliers. As a result, a large number of the deals struck in the mid-market during 2005 and so far in 2006 have included significant earn-out components in the transactions.

For those areas of the market experiencing high growth, primarily those highlighted above, the larger suppliers are favouring the option of buying niche providers of such software or of buying just their IP, in both cases reducing the risk of internal development failure and fast tracking time to market. The acquisition of TLC Risk Solutions by Temenos Group in 2006 (TLC advised by Westchester) was a prime example of this strategy. It is in this area where we have typically seen the highest valuation multiples.

We are seeing high levels of M&A activity amongst European firms in 2006, and an increasing number of US companies actively looking to expand into UK/Europe by acquisition.

The majority of trade acquisitions that we have seen have been made by public companies as the current high market valuations of these firms are enabling them to acquire assets typically well below their own valuation levels.

Key areas of M&A focus

Moving forward we believe the hot market areas will follow the pattern already set in 2006, as we expect these areas to continue to be at or near the top of the shopping list for the larger financial technology firms.

Regulatory compliance

Regulatory driven compliance and risk management issues are still at the top of the IT agenda for most financial services firms, although the emphasis has now shifted from BASEL II/ SOX (primarily banks) to MiFID (buy-side and sell-side institutions).

The Markets in Financial Instrument Directive (MiFID) is the most wide ranging piece of legislation to hit the European investment markets to date. The timetable defined for MiFID compliance (November 2007) will mean that many software and solution suppliers to both the buy and sell sides will have limited time to enhance existing solutions or build new solutions to meet the needs of their customers. As a result it is expected that suppliers will seek to acquire companies providing software across a number of the areas that are critical for MiFID compliance. The key areas from an IT perspective being *Best Execution* (pre-and post-trade transactional cost analysis and reporting technology), *Pre-trade Transparency* (publishing of prices and order books, requirements for data publishing, data storage and reporting technologies), *Post-trade Transparency* (further requirements for data storage, content management and reporting technology) and *Client Classification / KYC* (requirements for advanced client risk profiling technology).

MiFID related M&A activity is expected to accelerate during the remaining part of 2006 and into early 2007. So far there have been a limited number of relevant transactions, the best and most recent examples being Thomson Financials' acquisition of Market Systems. Inc., in April 2006 adding transaction cost analysis software to its product suite. In addition, ITG acquired JPMorgan's Plexus unit in September 2005 to offer TCA services to their buy-side customers.

In terms of Basel II and Sarbanes Oxley (SOX) compliance, traditional banking software and service suppliers have now largely either built or acquired solutions to provide entry level regulatory risk management solutions to banks. As the deadline for Basel II compliance approaches, we expect the emphasis to now shift towards the provision of more complex enterprise risk management solutions (ERM) to facilitate more efficient management of capital. There have been a number of notable transactions to date in this area including; FRS' (S1) acquisition of Providus in June 2005 (regulatory and financial analytics and reporting technology), the Misys acquisition of Almonde in July 2005 (Basel II credit risk technology), and Temenos' acquisition of TLC Risk Solutions in January 2006 in which Westchester advised TLC <http://www.westchester.co.uk/news20060130.html>.

The other significant regulatory change is 'Unbundling' where from January 2006 investment firms are required to split out the element of commission and fees attributable to the provision of research services. This is expected to lead to increased IT spending to quantify the value of such services, and in turn we expect to see the traditional buy-side firms acquire companies offering the type of qualitative and quantitative analysis capabilities required to meet this requirement.

The influence of Hedge Funds and cross asset trading strategies

Hedge funds and structured products continue to drive growth in underlying assets, and in turn are driving the increased use of derivatives across all market segments. This means that the traditional asset managers are increasingly being driven to launch alternative investment strategies by their institutional clients (pension and insurance funds). Many of the traditional suppliers on the buy-side lack both the application functionality and the domain knowledge required to meet these complex requirements and in most cases are looking at acquisition as their preferred route to market. A notable acquisition is Beauchamp Financial Technology's acquisition by Linedata

Services in November 2005. We expect this trend to accelerate during the remainder of 2006 and into 2007 as hedge funds gain further traction in the market.

Hedge funds have been one of the main catalysts for the development of ASP delivery models (see later), enabling providers to expand their market to the small and medium sized firms.

The increased usage of and trading volume in derivative and structured instruments across all segments, but driven in particular by hedge funds and algorithmic trading, is causing downstream processing issues in back office technology which is unable to cope with the new instruments and trading volumes. This dynamic is particularly acute in the asset management sector where STP risk is compounded by the lack of derivative domain knowledge and transaction processing functionality from the trading room through to the back office.

We expect there will be a number of transactions in this area in 2006 and 2007 as suppliers attempt to plug this gap in their product offering. Thus far, the most notable example is Factset's acquisition of Derivative Solutions in August 2005 (portfolio analytics and management software).

Buy-side and sell-side technology convergence

We are seeing a rapid convergence of sell-side and buy-side techniques and technology with Direct Market Access and algorithmic trading being two of the key drivers. Typically the sell-side suppliers have been strong in these areas and are well positioned in most cases to attack the buy-side for a number of reasons. The buy-side is increasingly trading in instruments that were traditionally the bastion of the sell-side. The buy-side is increasingly trading directly rather than through the sell-side, using Direct Market Access, algorithmic trading and execution management technology. Hedge funds are accelerating this convergence through active use of complex instruments and trading strategies.

It is expected that many of the traditional buy-side suppliers, sell-side suppliers and sell-side firms will be looking to acquire front office technology to meet the needs of their institutional clients during 2006 and 2007. The sell-side firms have been first to capitalise on this trend with a number of acquisitions already completed, good examples of this being Lehman Brothers' acquisition of Townsend Analytics in December 2005 to bolster Direct Market Access and execution management offerings, and JP Morgan's acquisition of Neovest in June 2005 to offer Direct Market Access technology to buy-side clients.

New delivery models

The move towards the ASP-based delivery model is accelerating, driven by advances in technology combined with the need to reduce the cost of ownership for customers and the cost of maintenance for suppliers. In the buy-side segment, hedge funds have been a catalyst for ASP delivery models as the large number of small funds with small IT departments are well suited to the ASP model. The result of this from an M&A perspective has been software suppliers, particularly buy-side suppliers looking to

acquire both ASP technology and expertise. A recent example being Statpro's acquisition of Alphai, in which Westchester advised Statpro <http://www.westchester.co.uk/news20060418.html>.

Liability Driven Investment Strategies

The concern over long term pension liabilities is fuelling the growth of Liability Driven Investment (LDI) strategies, and consequently the increasing allocation of investment portfolios into fixed income and credit instruments.

This growth of LDI in turn is driving demand for software focussed on the trading and management of fixed income securities and portfolios, and Asset Liability Management (ALM).

From an M&A perspective we expect there will be a number of acquisitions in this area as suppliers seek to boost their capability and product sets. The complexity of processing and the high levels of domain knowledge required make the buy option more likely than the build option for many companies, Bloomberg's recent acquisition of Brainpower in May 2006 offers a good example.