

Financial Technology in 2004 and 2005 – Market trends and M&A drivers

In this review we firstly summarise some of the key trends that are currently influencing financial services firms and, therefore, their technology providers and then highlight the drivers behind the increasing M&A activity within the Financial Technology community. First, a summary of our conclusions:

Key Market Trends:

- Regulatory driven compliance and risk management issues are still top of the IT agenda for most financial services firms, with Straight Through Processing "STP" still on the wanted list due to continued focus on cost efficiency
- Hedge funds and structured products are the 'must have' new product areas

Key M&A Drivers:

- The realisation has struck for many smaller financial technology suppliers that size really does matter and that more than ever, customers want to buy from larger suppliers. As a result, the majority of market segments are forecast to experience increased levels of consolidation
- For those areas of the market experiencing high growth, primarily those highlighted above in Market Trends, the larger suppliers are favouring the option of buying niche suppliers of such software or buying just the IP, in both cases reducing the risk of internal development failure and fast tracking time to market
- Although we are seeing increased levels M&A activity amongst European firms going into 2005, we are also seeing renewed activity by US companies wishing to expand into Europe by acquisition

Market trends

Hot areas in 2004

Corporate actions, risk, compliance, performance and outsourcing were the main areas of IT focus during 2004. Regulatory driven compliance and risk related issues such as; fraud reduction, disaster recovery, operational risk and Know Your Customer (KYC) were of the highest priority. The interest in cost cutting through greater processing efficiency (STP) and IT outsourcing was not as pronounced as in 2003.

Hot areas in 2005

Compliance and Risk

As in 2004 these are the main destinations for increased IT budgets, driven largely by regulation (e.g. Basel II, Sarbanes-Oxley, European Savings Directive). The weight of these regulatory demands is forcing many other IT areas further down the list of priorities.

STP

After many years of implementing STP or trade process management solutions to streamline the traditional investment and banking processes, the focus has now turned to the processing of derivatives and exotic instruments which although are smaller in transaction volume, represent a much higher level of risk. This is partly due to the increased use of such instruments by mainstream asset management and investment banks but more to do with the alternative investment strategies adopted by the ever-widening array of hedge funds.

Data warehousing

Best of breed is a well used term, but in order to implement this IT Strategy effectively, most firms have realised the importance of having a good data warehouse to manage the collection and cleansing of multiple data sources, and onward dissemination to multiple satellite systems.

Outsourcing

Whilst the majority of stakeholders in the market expect that Outsourcing will continue well into 2005 and beyond, the success of this strategy is still unproven. Firms are, however, still drawn by the dual proposition of significant cuts in operating costs combined with the 'core competence' strategy. Recent examples have included Insight Investment's outsourcing to Northern Trust and Standard Life outsourcing to Citigroup.

Whilst the trend for 'Commoditised' outsourcing continues, providers are now looking to extend their offerings to cover growing areas such as hedge funds (prime broking) as well as moving into the mid office through the provision of ASP-based order management capabilities.

The number of outsourcing organisations (including Prime Brokers) in existence and the concentration of business amongst a small number of large providers leads us to the conclusion that there will be growing consolidation amongst suppliers during 2005 and beyond.

Hedge funds

The hedge fund scramble has everyone wanting a piece of the action. For financial services firms and technology vendors alike, 2005 looks to be another year of trying to gain exposure to hedge funds.

Cold areas in 2005

With the exception of those areas listed above, which are forecast, as in 2004, to consume the majority of IT spend in 2005, most of the other traditional software segments including back and mid office software are forecast to be flat during the year. With firms looking to make better use of what technology they already have employed in these areas it is likely that, with the exception of a few firms, most will adopt tactical solutions involving a collection of best of breed components around a robust STP process management, workflow and data warehousing IT architecture. This is evidenced by the relatively small number of firms adopting replacement of back office core processing systems in recent years.

M&A Drivers in Financial Technology

Smaller firms (sub £10M) need to scale up

The smaller firms that have managed to survive the last four years of downturn have generally survived through vigorous cost cutting programs at a time when new sales in traditional markets have been thin on the ground. As you would expect, these firms are typically those with at least 50% of their revenue coming from recurring sources, and are typically servicing sizable customer bases usually built up over a period of many years from the sales of 'legacy' technology. The investment constraints over this period have also resulted in low levels of R&D in next generation products to replace their legacy product sets. Consequently, a large number of these firms are running on empty and some will have a limited life. For those that do have a product in demand, the strategy of merging with an entity with a strong sales and marketing infrastructure is likely to accelerate.

Larger firms add via acquisition

For larger companies with a modern and complementary product set, the strategy of acquiring smaller companies with a valuable customer base and a healthy level of recurring revenue also looks set to grow during 2005. Indeed, the continuing growth of many of the mid and larger sized firms has been in part due to this strategy. This ties in with three out of the four top business drivers for technology supplies and financial services firms alike: the desire to achieve incremental revenues from existing clients; the desire to grow market share; and the desire to achieve further cost reduction. Notable examples of this in 2004 have included Microgen's acquisition of AFA Systems and WMS's acquisition of Fairs.

Consolidation strategy is still alive and well in many sectors

Few Financial Technology suppliers truly have the scale and scope to generate sustainable revenue and profits, especially as new sales opportunities are often limited to the growth areas or those driven by regulatory pressures. Therefore, consolidation and cost savings is one way to increase and sustain revenues and profits. Most of the notable acquisitions of banking and asset management software companies in the recent past have been driven to some extent by this strategy. Examples include Sungard's Acquisition of FTI, the Reuters acquisition of Telerate, S1's acquisition of Mosaic software and Experian's acquisition of America Software. This strategy looks set to continue into 2005 with SS&C's tabled acquisition of FMC.

Transferring significant components of post acquisition development and support activities to India or other countries has been a key driver in the cost reduction opportunities possible through consolidation driven acquisitions.

There are several market segments where we expect significant consolidation during 2005 and beyond, these include:

- Back office banking and asset management software - wholesale banking system, treasury system and asset management software vendors will consolidate as buyers seek to acquire legacy customer bases, enhance profitability and/or embark on a replacement strategy with technically advanced solutions. Most tier one, two and three firms already have a working solution and if they do replace a system are most likely to buy from a larger vendor.

- STP and middleware software - as for the banking software, buyers will seek to acquire legacy customer bases, enhance profitability and/or embark on a replacement strategy with more technically advanced solutions. Most tier one and two firms have already deployed an STP solution successfully.
- Outsourcing – As described earlier, the number of players in this market and the concentration amongst larger providers means that consolidation of the small and mid sized firms is highly likely. Although there has been little sign of this to date, a recent example was JP Morgan Chase’s acquisition of Tranaut.

Good IP in large growth markets still supports a high price

Although the Financial Technology market is dominated by consolidation and the drive for market share, there is still a market for technology suppliers with good quality IP. Most financial institutions are more unwilling than ever to incur the risk of developing replacement or new products based on new technology when anecdotal evidence suggests that more than 50% new software development projects fail. Having identified a growth market of interest, it is typically much better to acquire a fully developed and tested product where one exists - ideally with a few live customers - and then leverage the much larger customer base of the acquiring company. Recent examples of this include Seibel’s acquisition of Ontec and the Tiger Telematics acquisition of Integra SP, in both cases the sellers commanding high valuations. Strong companies will still pay high-quality valuations for proven IP that targets high growth markets, enabling the acquirer to enter the market sector on an accelerated basis with fewer product “risks”. We expect this trend to continue, as many end-user organisations are increasingly unwilling to buy from small suppliers whom they see as risky, regardless of how well the products meet their needs.

Well-established companies buying into new product/market areas

We expect the trend of larger, well-established technology providers looking to acquire an entry into new product sectors in preference to organic development to continue after significant activity during 2004. The key areas of interest continue to be compliance and risk management, money laundering / fraud detection, payments processing and STP. Recent examples have included Sungard’s acquisition of Protegent (Compliance and Risk), Experian’s acquisition of America Software (anti money laundering), Metavante’s acquisition of prime associates (anti money laundering) and of Advanced Financial Solutions (AFS - payments solutions), and finally, Morgan Stanley’s acquisition of Barra (risk reporting and analytics). On the consultancy side, Morse acquired CSTIM to increase their exposure to the asset management sector. Given that many of the larger providers are US based, we are beginning to see renewed activity from such companies wishing to acquire their way into the European market as their preferred method of geographic expansion.

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