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Fintech M&A: The future of dealmaking post Covid-19

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After a run of high-value deals at the start of the year, fintech M&A has dramatically slowed. What will dealmaking look like in the future?

For investors in the fintech market, the contrast could not have been more stark.

In the first quarter of 2020, financial institutions, financial sponsors and mature fintech companies generated a series of increasingly high-value deals.

Among them we saw:

– Visa buy fintech start-up Plaid for USD5.3bn;

– Morgan Stanley acquire E-Trade for USD13bn;

– Worldline buy its payment services rival Ingenico for USD8.6bn; and

– Intuit take over the personal finance portal, Credit Karma, in a USD7.1bn cash deal.

As we enter the final quarter of 2020, the picture has changed.

As the Covid-19 pandemic took hold across the world, fintech transactions went into rapid decline, mirroring the pattern of steeply falling deal activity across almost all sectors and regions.

Listed fintech companies, which had comfortably outperformed the S&P 500 and Nasdaq before Covid-19, were significantly undershooting these indices afterwards. Similarly, those fintechs whose businesses focus on sectors which are hardest hit, such as travel or entertainment, have suffered disproportionately.

In reality, the impact of the crisis on this historically vibrant market is more nuanced. There were noticeable changes in sentiment even before the pandemic.

Traditional banks and financial institutions were already expressing concerns about over-inflated valuations in the sector.

Venture capital funds, which have poured billions of dollars into the sector in recent years, were also taking stock and reining back investment. Indeed, Q1 2020 was the worst quarter for VC fintech investments since 2017[1].

Against a backdrop of rapidly rising valuations, we were beginning to see potential investors switch to other strategies. With the **Buy** option looking increasingly pricey, the focus was already shifting towards **Build** (developing fintech solutions in-house) and **Collaborate** (forming alliances, or partnering with promising start-ups through joint ventures or, more likely, through minority investing).

[1] Source: https://www.cbinsights.com/research/report/fintech-trends-q1-2020/

How have things changed for fintechs?

Valuations are beginning to come down in the short term as the sector swings from a seller's to a buyer's market. But there is little sign yet that price expectations have become truly aligned.

The pressure on high-growth companies to raise new funding has become more intense. Even companies that were close to achieving 'unicorn' (USD1bn valuation) status ahead of the pandemic, have been forced to scale back their ambitions. Others have retreated on expansion plans and announced office closures and redundancies.

The situation is particularly acute for those companies at the very earliest stages of development. The short-term focus for these businesses is on survival. Companies are hunkering down to preserve cash to make it through to the next scheduled fund raise or revenue event.

Where the need for fresh finance is more immediate, we have seen the emergence of so-called 'down rounds', where companies complete a fund raise at a lower valuation to the one used in their preceding financing round.

Historically, down rounds have been rare in key fintech markets, not least in the UK. The change in market dynamics has already started to affect a range of market participants, even well established players.

Down rounds are not a comfortable exercise. They are, in PR terms, comparable to a listed company issuing a profits warning. And they can lead to wider problems, such as triggering anti-dilution provisions and potentially other mechanics within the relevant constitutional and contractual arrangements.

To avoid this outcome, some start-ups have looked for alternative financing solutions, including raising money through the issue of convertible loan notes (thus deferring the question of valuation) or through exploring venture debt.

In some jurisdictions, governments have stepped in to invest in minority stakes in promising early-stage companies that may struggle to stay afloat. The UK's *Future Fund* and Germany's *Corona Matching Facility*, are two examples.

Such schemes could in some circumstances be a life saver. But the terms of that support and the impact it will have on other investors, not least the changing in stakeholder dynamics a government shareholder creates, call for careful consideration.

Is this the right time to invest?

Valuing high-growth businesses is tricky in any environment and the pandemic has only made that process harder. That is particularly true of early-stage companies where there are fewer financial metrics to assess the medium- and long-term growth potential of the business at a time of pending recession, the depth of which is still too early to predict.

Potential acquirers are bound to ask themselves whether it makes sense to invest at this most uncertain of times. On balance, the reasons for doing so can be compelling.

Covid-19 and the lockdowns imposed by governments across the world have accelerated consumer adoption of online financial services, leading to a rapid expansion of e-commerce and online banking, as people shift away from paying by cash at physical retail locations.

This steep rise seems unlikely to be reversed, even once lockdown measures are eased globally. Consumers and businesses increasingly expect to interact in a wholly digital environment and financial services is no exception. Increased use of digital technology is also driving demand for more sophisticated tools to manage and compare their accounts and financial products online. The UK's trailblazing work in establishing the country's open banking implementation framework has already driven substantial innovation and investment in data aggregation platforms and infrastructure.

Traditional banks – even those with well-developed digital strategies – still have much work to do to identify and adopt tech solutions that will allow them to meet the threat posed by online challenger banks and other disruptors. Their need to invest in fintech solutions has not gone away.

Regulators have generally been encouraging of innovation (with many establishing fintech 'hubs' to support product testing and development) and have allowed firms to grow with minimal supervision. However, as the market has matured – and some firms have taken up notable market share – regulators are applying increasing pressure on compliance with capital, consumer protection and financial crime rules. The well-publicised failure of players like Wirecard and Ipagoo may give investors pause.

In addition, with a recession looming, renewed pressure on the profits of some traditional banks is likely to force them to look for new cost savings and inevitably accelerate the adoption of tech solutions and innovation-led transformation.

There will be many potential targets. Fintechs, for all their short-term cash preservation challenges, may be well positioned to see out the downturn. They tend to be very lean organisations, free of the sort of supply chain disruption problems that can affect bigger operators.

There are also digital-first businesses often with market-leading abilities to harness and exploit data and entirely comfortable with doing so while working remotely. In other words, the case for investing in fintechs remains a strategic priority.

In the end, it is more about how, rather than if, deals will be executed, and the strategies investors need to adopt in this changed world.

So who will be buying and how?

Given the uncertain market, traditional investors have held off high-value strategic deals in the short term.

There may, however, be scope for some opportunistic moves by investors looking to take advantage of the collapse in valuations.

Some investors, including financial institutions and funds, may well look to do distressed M&A deals as the market shakes out.

Moreover, just because most investors are shying away from big-ticket transactions right now does not mean they are inactive.

Cash-rich funds, for instance, are certainly assessing potential future acquisitions so that they can move in quickly on chosen targets when the outlook becomes clearer and valuations settle.

Private equity funds, for example, have already been active in the payments market, but the crisis could present opportunities for them to reach wider and deeper into the fintech sector. In particular, it may open the way for modular or buy-and-build opportunities, perhaps bringing a retail banking operation together with a cross-border payments business to create a viable challenger banking operation.

Mature fintechs could re-enter the market, provided they have the funds. Some have already signalled their willingness to do deals, including Santander (which has recently launched a new fintech capital fund – Mouro Capital) as well as the online banking group, Revolut.

In recent months, Facebook has also continued to be active in that part of the market where payment systems and e-commerce intersect, launching services in various markets.

It has been adopting a collaboration strategy, willing to invest in or team up with potential competitors to test new markets and new regulatory regimes. Alongside PayPal, for instance, it joined the latest funding round for Gojek in Indonesia, securing a small stake in GoPay.

We are likely to see strategic collaborations and minority investing of this kind proliferate over the coming months, particularly where it allows investors to gain exposure to new technologies and markets on a 'try-before-you-buy' basis, with the potential to make a more substantial investment later.

Other areas of fintech that look ripe for heightened activity include:

– insurtech;

– digital ID and anti-fraud technology (particularly in light of recent EU calls for a pan-European ID scheme to aid know your customer efforts);

– online lending;

– wealth management; and

– electronic record keeping, including broader applications of distributed ledger technology.

Responding to increased demand for digital banking services will remain a challenge and a priority for traditional banks.

For banks, as for other investors, a key focus is likely to remain on minority investment in promising technologies and the teams behind them.

We also expect to see an increase in collaboration and strategic alliances as an alternative to out-and-out M&A transactions, at least in the immediate aftermath of the pandemic. The urgency of delivering on a digital strategy could force the pace of this activity.

For their part, the legacy institutions bring a number of enticing benefits to an aspiring fintech, not least a wealth of capital, a more developed and well-resourced regulatory and compliance infrastructure and an often very loyal customer base. It is easy to see why a collaboration will often be a tempting prospect for a tech company.

Pitfalls ahead

Even before the current crisis, traditional players looking to invest in fintech were on a steep learning curve. Many of the factors that add up to a successful investment strategy still apply, but the importance of some have been amplified by the crisis.

Issues that investors need to consider include:

– **Cultural difference** – The culture of a start-up or high-growth company is very different to that of an established big business – leaner, faster moving and less bureaucratic. Bringing those two cultures together successfully requires careful management.

– **Integration first** – Integration needs to be front of mind from the outset, before detailed due diligence gets underway. This is a model followed by many of the most successful tech companies when they go out to acquire new technologies or new talent.

– **Compliance** – Compliance processes and procedures in established companies will invariably be more sophisticated and more extensive than in a start-up. We have seen a number of potential deals come close to foundering because the start-up simply did not have the ability to invest heavily enough in compliance systems. Though such issues can be assessed by well-drafted warranties, it may not be possible to obtain sufficient comfort and they can prove decisive in whether a deal proceeds or not. Moreover, as financial institutions increasingly invest in early stage fintechs, the enhanced scrutiny to which fintechs are now subject will bring regulatory considerations to the fore. Where investors have a US presence, regulatory (including financial crime) issues will be front of mind.

– **Walk-away rights** – Minority investment deals often include a right for the investor to abandon its investment, particularly in the financial services sector, allowing the investor to put its entire investment on the company for a nominal sum if and when such problems emerge. With a full-blown acquisition it is, of course, much harder to walk away.

– **Keeping teams on board** – The real value of a start-up often lies as much in the people behind the business as in the innovation they have developed. Making sure they are properly vested in the combined operation through effective management incentivisation is vital, whether that takes the form of shares, options or other package of remuneration. Nevertheless, things can go wrong, at which point ensuring the company and investors are sufficiently protected through appropriately negotiated non-competes and management equity vesting provisions becomes key.

– **New issues in a buyer's market** – With the balance of power swinging from seller to buyer, fintechs seeking funding or an exit will find themselves in a new and much trickier environment. Expect more conditionality in deal terms with warranty protections and repetition of warranties likely to feature more widely to ensure the buyer is properly protected. In addition, investors will continue to demand preferred status on liquidation events to secure the value of their initial investments and, where possible, guarantee a return (whether through an M&A exit or administration of the target), and anti-dilution provisions will continue to be a staple of minority investment deal terms.

– **Cyber risks** – For any online, data-rich business, falling victim to a 'hack' continues to be a material risk factor. With that comes operational challenges for fintechs seeking to integrate or provide products to established financial institutions, whose data security protocols have become increasingly costly and onerous for early-stage businesses to comply with. Equally, cyber risks do not go unnoticed by investors now that fines under GDPR can materially alter the economics of a deal, bringing with it increased focus on data protection due diligence together with robust cyber/data warranties and indemnities where appropriate.

- **Greater antitrust scrutiny** – Regulatory oversight of tech companies is increasing rapidly as the pressure mounts on the authorities to ensure that antitrust rules are fit for an increasingly digital and globalised world. This is a debate that has increased in light of the speed of recent digital transformation during the Covid-19 epidemic. In June 2020, the European Commission unveiled its plan for potential action to address these concerns, the most radical part of which is the proposed ex ante regulation of digital platforms.

  The potential market dominance of the very biggest tech companies, and their ability to stifle competition by snapping up small businesses that might one day be challengers (so-called 'killer acquisitions') is coming under increasing scrutiny from the regulators. In the payments segment, the spotlight is on Apple Pay and Google Pay, with the European Commission (Apple Pay) and Indian authorities (Google Pay) looking respectively at their activities.

- **Greater state involvement** – The crisis has led to greater state intervention than we have seen for many decades across sectors and jurisdictions. This is particularly evident in the area of foreign direct investment, where tougher controls are being imposed on the grounds of national security or public interest. While most fintech companies would be unlikely to be seen as systemic in the same way that major too-big-to-fail banks are, this could begin to change as the industry matures and as challenger banks grow. State investment in struggling fintechs, as described above, could also be a double-edged sword. Short-term security could come at the cost of longer-term complexities around ownership and political interference.

The road ahead

The fintech sector enjoyed a period of extraordinary growth following the financial crisis.

While the pandemic has certainly brought that period of unbroken development to a halt, we believe we are experiencing a hiatus in fintech investing rather than an existential challenge to this still buoyant sector.

Growth may take some time to return to pre-pandemic levels. But an eventual resurgence does look probable, even if the pattern of investment changes in the short term and investment committees remain cautious for a few months more.

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