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Dealmaker Roundup Q3 2019

New Frontiers in Financial Services

Privcap assembled a group of private equity experts for an in-depth conversation about the investment opportunity in financial services. Commentators include **William Spiegel** of **Pine Brook** and **Anthony DeCandido** and **Michael Fanelli** of **RSM**. Topics include the decline of legacy players in financial services, the futility of traditional banks serving coffee, the disintermediation of mortgage brokers, and the removal of capital from the value chain.

The Experts

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Privcap: We're going to learn about what's going on in the private equity deal market. The three of you are very active and I'm fascinated to hear what you are observing. Because we have two financial services experts with us, William Spiegel and Anthony DeCandido, it's a great opportunity to also take a deeper dive into what's going on with regards to private equity dealmaking, specifically in the financial services sector. Why don't we get started? First of all, what is the sentiment in the private equity deal market generally and what's driving deals? We can start with Michael Fanelli.

Michael Fanelli, RSM: There continues to be extreme competition in the marketplace, especially for middle-market private equity deals. The level of dry powder and capital available continues to exceed the number of quality companies available for sale. Speed and certainty to close remain important. Typically, the highest value is going to win most of the time, but not all the time. Sell-side investment bankers are trying to educate their clients and saying, "Buyer A is slightly higher from a valuation perspective, but we think Buyer B has a higher chance to actually close this deal, and close it in a very expeditious fashion, so we suggest you go with Buyer B." It's hard for the sellers to get their arms around that, especially if they've never done a deal before.

We're also seeing buy-side clients call us very early on. Recently, we've done a ton of what we call "phase-one, pre-LOI" work before they get exclusivity. Again, this goes back to the competition in the marketplace. They're asking us to do work prior to receiving

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exclusivity. It's to show the sellers and the bankers that they're highly interested, they're spending money, and they're learning about the business. Sometimes, if they feel really good, they'll sprint at it.

I'm interested to hear William's [Spiegel's] and Anthony's [DeCandido's] perspective to see if there is the same phenomenon in the financial services sector, in terms of competition and what sets buyers apart, which sectors are hot. Because I know we're seeing a ton of deals in fintech and specialty finance.

William Spiegel, Pine Brook: I think buyers are quite discerning, despite this wall of money, despite living in a low-rate environment and a president who is pushing for negative rates, which is going to force everyone into risk assets. But I think you also need to take this apart and ask which companies are doing well and which are not? It's easier to sell a non-cyclical company, and I'll hit on that in a moment. It's easier to sell or take public a tech-enabled company. It's obviously easier to sell a company that has strong cash flows – there will be lots of PE interest, and even strategic interest.

Companies that are balance sheet-oriented are generally more challenged. I think this is a hangover from the Great Financial Crisis. It's still with us. Many of us lived through it and we're still scared. There's a reluctance to do deals, whether they are balance-sheet or not. We don't want to look silly if a recession comes. All we read in the newspaper is, "The recession is coming! The recession is coming!" It hasn't come, but eventually it will. I joke every day that we're a step closer to a recession.

Multiples are high for services businesses. They're low for credit businesses because of cyclical low rates and there's fear of technological disruption. Why are deals getting done? Strategic deals are getting done for consolidation and for scale. If you're in a traditional financial services business, you're a price-taker in the market. And if you're a price-taker, the only difference that you can have is better overhead, better G&A, and better financing. Scale and size matter, of course.

Anthony DeCandido, RSM: If you expect an M&A slowdown, you may be disappointed, because we're just not seeing that at all. In June 2019, the M&A transaction bell hit an all-time index reading. A lot of the dislocations that you're seeing within supply chains are creating opportunities for private equity firms. A lot of these dislocations that have occurred are presenting opportunities for managers to differentiate themselves within their peer groups. If I could kick it back to William, I'm interested to learn more about some of those technological disruptions you're speaking of and seeing within your target market.

Spiegel: Everyone talks about fintech. I think we will not be using the word "fintech" in seven years. The reason for that is, if you haven't as a company embraced technology in some way, you'll be out of business. So, fintech is just going to be financial services. It's going to be what you need to compete. We're at a funny time right now where tech companies trade on multiples of revenue, because many of them haven't been able to make money. That wall of money I talk about in PE Adventureland has been willing to pay really big multiples of revenue.

And yet, when we see these companies go public, we're watching the public markets discipline the private markets. If you look at Uber, WeWork, Slack, SmileDirect, Peloton – these are not financial companies, but they probably could've raised money in the private markets at a higher valuation than where they were able to raise money in the public markets, or certainly trade better than they're trading now, because they're all down. I think some of this growth feels a little toppy when we're trading at seven or 12 times revenues as opposed to actually looking at companies that make money. That's the view I have on the overheating of the tech market.

You asked about what are we seeing in terms of disruptions – it's very interesting. I'll list a bunch of companies, some of which didn't exist a number of years ago: SoFi, Stripe, Credit Karma, Robinhood, N26, Better Mortgage, Fair Square Financial, Lemonade, Kin. Some of you know these companies and some of you don't know these companies. Some of these companies, like SoFi, have even

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MARKET STATISTICS FROM preqin

$3.6 Trillion Private equity market AUM at the end of 2018	**1150** Number of buyout deals in Q3 2019	**$86 Billion** Aggregate value of buyout deals in Q3 2019
$476 Million Average size of buyout deal in Q3 2019	**$16 Billion** Financial services private equity deal volume in 2019 YTD	**$300 Million** Average deal size in financial services

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had Super Bowl ads and they now have stadiums named after them. But they didn't exist a number of years ago. What do these companies have in common? They are trying to modernize a very, very old industry – an industry that is traditional, that has done things in a certain way and has been protected by regulation appropriately. But I look at a lot of these older companies now and I'm not going to use names, but we know who they are. They are Blockbuster versus these new companies being Netflix.

These new companies are threatening the likes of J.P. Morgan and Schwab and Travelers because they don't have any legacy. I use "legacy" broadly. They don't have any tech legacy, they don't have any origination legacy, they don't have any human resources legacy.

With regard to the older companies, we're at a funny point where smaller and growing companies are more efficient than larger companies, which used to have scale. Think about it for a minute: If you were starting a bank today, you would not have bank branches. But yet one of the largest banks in the country, which has a lot of branches, has ads out there inviting people to coffee shops in their branches. The only reason you'd ever convert a bank branch to a coffee shop is because you're long real estate. You would never do that otherwise.

If you are a homeowner insurance company, you wouldn't start a business with agents today, where you're paying an agent a commission every single year. Instead, you would actually go direct to the consumer and you'd pay two years of origination cost and get the remaining seven years on that policy for free in terms of not paying an originator.

So, how does an existing legacy company go direct-to-consumer? They can't without destroying their origination channel. I really think we're at a very exciting time in financial services where, across every single sector, the smaller companies have an advantage. They can originate less expensively. They can bring on modern machine-learning tools. They have access to data. They have alternative data that they can use. They start themselves in the cloud. They can recruit younger people.

The reason I mentioned all those companies at the beginning is because these new companies actually have an advantage over the legacy companies. The legacy companies are probably going to have to buy these companies, or they're going to be out of business in the next 10 to 15 years. It's a really exciting time and it's all about cost. In my mind, technology is about cost. In a perfectly competitive industry: If you have a lower cost structure, you'll win. We're in a competitive industry and I think these new guys are going to win.

DeCandido: We look at it through the lens of, what's happening in middle market? These middle-market businesses that are looking to implement new technologies, but they might not always have the level of sophistication or even the capital to execute on some of their technological strategies. That's where we are able to play a very important advisory role to them, particularly in the markets where tech is making the biggest impact. Just four years ago, we saw about half of the technology deal activities we're seeing today. Last year we saw 4,100 technology deals. So, technology is becoming much more critical to our middle-market businesses that are looking to drive those operating agendas.

Spiegel: You need to look at every business you're investing in and say, "How can existing, off-the-shelf technology improve my cost structure?" It's harder to do that in the public market. When you're public and you start spending money and potentially even losing some money, even if it's one-time costs, you get punished. In the private markets, you can build a business and create long-term value. Even though sometimes buying and selling companies over a five- and seven-year period seems like a short period, it's actually a very long period to set a company up for ultimate success and not worry about what the quarterly earnings look like.

Privcap: William mentioned that, in many cases, the disruptive, smaller companies are naturally getting acquired by the legacy players who fear getting run out of business. Are you seeing private equity firms making investments into more disruptive types of companies already having in mind the potential acquirers of those companies down the road?

Fanelli: Especially in financial services with a technological lens to it, private equity firms have the end game in mind as they build a thesis on a sector, and portfolio companies that they're looking to acquire. For the vast majority of these companies they're looking to acquire, and for which they are building relationships, the end game is already in mind. They may play for a key sell to a strategic or a larger PE firm or family office. It is often the investment thesis very early on, even at the origination stage.

Spiegel: Strategics need to own these companies. I don't know if they realize it yet, but in the next five to 10 years, they're going to realize that they are falling behind. It's very hard for a large company to think about what it needs to look like in the future, as opposed to dealing with the corporate development actions of the larger problems that they're facing. They're not able to start in the cloud. They have to deal with legacy systems. They have to re-recruit different people. They're dealing with big problems. They're creating this area for these smaller companies to grow into and take share, but not yet quite be noticeable. But before long it's

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going to be too late and they're going to have to turn around and acquire these guys.

DeCandido: William, as you look for new deals, has your group adjusted your target profile of returns, given the changing rate environment?

Spiegel: That's a great question. The answer is, not for the way we invest. We're not a buyout firm. We are a growth-equity firm. We do what we call business-building. We look for dislocations around the financial services ecosystem. In our view, the financial services ecosystem is origination, underwriting, servicing and capital. We look for dislocations around that ecosystem to look for smaller companies and grow them. We haven't really found ourselves being forced to say, "OK, rates are lower and, therefore, we're only supposed to earn 500 basic points above the 10-year." We haven't really adjusted down our expectations on returns, but that's because of the style of investing we're doing. But I think returns in private equity over the last 30 years have come down because the rates have come down and the market is more competitive.

Privcap: Michael, when a company acquires another company to attempt an infusion of innovation and self-disruption, can post-merger integration be a challenge?

Fanelli: It really comes down to change management. We've all seen integration issues with a merger coming together. When you take two really good businesses and you mash them together, somehow they can't figure out how to manage the change, manage the change in leadership and the cultural aspect of it. Sometimes you just need a fresh step in the form of an acquisition and sometimes it's almost run as a stand-alone subsidiary, not even really integrated into the parent company. It comes down to culture, the difficulty of escaping the old ways of doing things, the challenge of getting out of old habits, and just overall change management issues.

DeCandido: Let's talk about data. I've been getting so many questions from clients lately relating to better ways they can organize and interpret data sets.

Spiegel: Companies today have to think of themselves, no matter their industry, as information companies. Maybe you're a data company that does credit cards, you're a data company that does mortgages or you're a data company that does construction. That's a new way of thinking. You used to think of yourself as, "I'm just a credit card company." But you're a data company because it's the only thing that you have today that's unique – your own data and how you interpret that data. Ninety percent of the world's data has only been collected in the last couple of years. When somebody told me that statistic, I said, "That's not possible," because the data has long been available. Well, it was available, but it wasn't stored. We didn't have sufficient computing power to store it. Now we can store it.

Privcap: What are your thoughts on traditional balance-sheet businesses?

Spiegel: It used to be that a traditional company would own its own capital. That made sense. For example, Travelers, a big company, had its own capital source by being public. Coming out of the Great Financial Crisis, a lot of investors realized that financial services companies create private investment opportunities that may uncorrelated with other things they were investing in.

We saw the growth of bank loan funds. We saw the growth of collateralized insurance vehicles. When you go back to my mini ecosystem – origination, underwriting servicing and capital – it used to be that a traditional company owned that whole value chain. Now, I think that we can start separating capital from the rest of the value chain, and that a modern financial services company doesn't need to own its own capital, because it may not have the lowest cost of capital. It needs to control its capital, doesn't need to own it. If you play out what I'm describing, you take a traditional balance-sheet company, and you actually make it an asset manager. It controls but doesn't own its capital. It has to be able to maybe own it at times, but to outsource it to others at a lower cost of capital. If you do that, you've created an asset manager, which doesn't trade at multiples of book value but actually trades at multiples of EBITDA. Or if you can't outsource all of your capital, then you've created a fee stream that will improve your return on equity and will make you trade at a different level.

DeCandido: Interesting. I just finished reading a great book called *Capitalism Without Capital* that was written by Jonathan Haskel. It talks about how all these major developed economies of the past always invested in traditional capital assets. But, increasingly, the investments today are being made in things like design, branding or R&D. So, software versus machinery. A lot of the successful companies today – the Apples of the world – their balance sheets are heaviest on assets that don't have traditional capital. It transcends every single industry, whether you're talking about a coffee shop, or gym or a manufacturer. It's their ability to design their business around intangible assets. ■

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