Fintech acquisitions: Integrations are a different adventure

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An interesting dilemma for those legacy financial institutions considering buying into Fintech; how to best structure the acquisition and integration of these companies in a way that enables their growth, while effectively managing their inherent risks?
In recent years, Financial Technology companies have emerged as an attractive growth alternative in an otherwise slow growth environment. The combination of native digital products, nimble operating model, and customer-oriented mindset has not only caught the eye of an early-adopter consumer base and a tech-savvy millennial workforce; but also attracted attention from Private Equity and established financial institutions looking for investments in high growth areas. The volume of acquisitions involving Fintech companies normalized in 2016, retreating from the record highs seen in 2015, with total deal volume totalling $13.7B, down 66% YoY. This decrease was due primarily to greatly reduced number of transactions valued over $1B, which accounted for over 90% of deal flow in 2015. Transaction volume in the space continues to be driven by volume below the $1B mark, as Fintech companies continue to receive attention from buyers both within financial services and as pure investment plays for private funds. This incredible growth is indicative of the attention these companies are receiving from buyers both within financial services and as pure investment plays for private funds. Which bring us to an interesting dilemma for those legacy financial institutions considering buying into Fintech; how to best structure the acquisition and integration of these companies in a way that enables their growth, while effectively managing their inherent risks?

Note: Total deal volume and number of transactions based on disclosed deal values.
Due to the disruptive and technology-forward nature of Fintechs, effectively integrating a Fintech start-up — or even a more established player — presents an entirely new set of potential challenges, even for the most M&A-savvy financial institution. These challenges, from clearly understanding what are actual products and capabilities versus ‘vapor-ware’, to preventing talent flight and maintaining growth trajectory despite operational friction, often result in many Fintech acquisitions failing to meet their stated objectives. But Fintechs are disrupting traditional financial services due to these differences and any FSI firm looking to harness this disruption should account for what makes these nimble new companies unique in their integration strategy.

An acquirer’s approach to due diligence should be informed by a target’s proximity to their core business. The space between a target’s business model and the buyer’s will have an outsized effect on the ease and success of a potential transaction and integration; the due diligence process should reflect this. While an acquirer may be comfortable managing the diligence process for a target in the same industry, it may prove necessary to enlist relevant subject matter advisors when evaluating Fintech targets. Furthermore, the target operating model envisioned for a potential Fintech acquisition should directly inform the due diligence process and inputs. A buyer should know which of the two operating models, a holding company model versus capability acquisition, best suits their overall Fintech strategy and structure their due diligence accordingly.

In our experiences advising clients in these types of transactions, we discovered a number of critical factors that can significantly enhance an organization’s ability to protect the sources of value and to realize the full potential of their investments.

### Aggressive assimilation vs preserve and retain

Two primary strategies of harnessing innovative Fintech are emerging in the marketplace that reside at opposite ends of a sliding scale of integration. The first is a capability driven strategy wherein established FSI firms seek to acquire and integrate new products, channels, or capabilities into their existing business portfolio to fill a gap and/or prepare for a potential market shift. The second adheres more closely to a holding-company model where the acquiring institution builds a portfolio of Fintech companies that continue to stand on the strength of their respective business cases while leveraging the scope and scale provided under the umbrella of the parent company.

Either of these strategies represents a viable path for an organization seeking to harness the innovation potential of new Fintech companies. And while the factors that should be considered in order to achieve integration of a Fintech into a more traditional financial services firm are consistent in both, the focus of each will shift depending on the strategy the acquirer has chosen to pursue.

Mature Fintech companies are also turning to acquisition as strategy to drive growth; this piece, however, will focus on challenges facing traditional FSI organizations considering acquisitions as a path to acquiring new capabilities or building a Fintech portfolio.

### Doubling down on due diligence

Despite their relatively small size, Fintech start-ups may be built on business models and technology platforms that are unfamiliar to legacy financial institutions. As such, they typically present a complexity that merits significant investment in appropriate due diligence of the target’s financials, commercial business strategy, risk practices & regulatory compliance, operations, technology, and human resources.

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2. Engaging and retaining talent
Talent is often a primary value driver in a Fintech acquisition. Many employees of a target may have joined these companies because they believed they were signing up to reshape an industry and now they might be joining the very firms they were trying to disrupt through no decision of their own. Beyond this change in mission, buyers should also address potentially radical differences in office culture and work environment, compensation, and attitude toward rules, risk, and regulation. For a firm attempting to build out capabilities through acquisition, finding a way to maintain this culture post-integration is key to helping prevent the talent flight that can often follow these transactions.

Culture can encompass elements from talent acquisition and talent management, how roles and responsibilities are defined, to how compensation is structured and are likely to be vastly different in Fintechs versus traditional financial services companies. Special attention should be paid to the titles given to newly integrated employees to ensure they accurately communicate their new role and seniority to the greater parent organization. Even the physical space in which newly integrated employees are located should be considered a critical element to be accounted for both pre and post integration. These softer aspects of integration planning can be key factors in retaining the very talent that made a Fintech company an attractive target and acquirers should seek ways to adapt their organizational structure to enable said talent to integrate, grow, and influence the organization.

A high priority consideration for FSI firms integrating a start-up completely into the parent company, cultural alignment and integration should not be discounted by firms following the holding company model, especially if any newly acquired Fintech companies will be co-locating with the parent.

3. Operating model friction
This culture shock can also pose new challenges operationally. Fintechs and their employees may be accustomed to more freedom around their technology (e.g. Bring Your Own Device, use of public cloud storage, emphasis on remote working, open source code) than is customary in traditional financial institutions. Integrating these new employees into a more controlled environment, one heavily governed by regulation and security policies, can pose a serious roadblock to productivity. FSI firms may want to examine carving out a new technology policy specifically for acquired Fintech firms that accounts for these differences and allows for continued technological flexibility while adhering to any regulatory requirements and permits new employees to interact with the rest of the company.

Firms should also consider how governance models should be structured to allow an acquired Fintech to continue to be nimble in delivering products rather than trying to force fit an existing approach for development and release of new products. Many new Fintechs may use Agile or Lean methodologies that, while widely used and understood in the technology sector, may not mesh well with a traditional FSI firm’s existing IT or Legal and Compliance functions. For those firms adding capabilities through acquisition, stakeholders on both sides of the transaction should be well briefed on expectations for engagement moving forward. Understanding how these two models differ and establishing a model for governance and interaction that addresses those differences while enabling the Fintech to continue innovating is critical to achieving value in such a transaction.

4. Ringfence revenue
In any transaction undertaken to drive growth it is important not to lose sight of what the major drivers of revenue are and assess whether they are not at risk. This is especially true in the case of a traditional financial institution seeking to expand its reach through an acquisition of a start-up. Early-stage companies are often single-minded in their drive for growth as a necessity and integration into a larger organization may dull that edge as time and resources are pulled to activities such as building compliance specs away from market-facing activities. Ringfencing revenue drivers can help the teams maintain their focus on revenue even as they integrate.

This continued focus on a Fintech’s revenue trajectory is typically of greater importance to an FSI firm following the holding company strategy as each company acquired will likely have to prove ongoing value as a standalone business. For those institutions seeking to fold in new capabilities, the due diligence process should account for the shuttering of independent revenue streams as acquired teams are absorbed into the parent. Lastly, acquirers should be sure to understand any regulatory constraints or legal entity implications that may require the shutting down of any revenue streams prior to acquisition to ensure the chosen integration strategy, be it assimilation or preserve and retain, aligns with regulations.

Acquirer’s dilemma — creating the right environment
For FSI companies looking to harness the disruptive power Fintech is introducing to the market, it is clear that the very factors that differentiate these acquisitions from traditional transactions are often what have allowed these Fintech companies to be successful thus far. Much of the success or failure of a legacy firm’s M&A approach to Fintech acquisition hinges upon its appetite for enabling the operational transformation necessary to create an environment inside the firm where newly acquired and integrated Fintech companies can continue to innovate with as little friction as possible. Barring this, it may better to follow a holding company strategy and allow each acquired company to continue along its own path to growth.