The Deal

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"Meet the Co-Opetition"
by Heidi Moore

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THE FINANCIAL SERVICES AND TECHNOLOGY BUSINESS ARE RIFE WITH CONFLICTS. FT PARTNERS' STEVE MCLAUGHLIN SAYS A LITTLE COMPETITIVE COOPERATION CAN HELP.

Ever since the $11.3 billion leveraged buyout of **SunGard Data Systems Inc.**, investment banks, hedge funds, private equity firms and venture capitalists have been circling the financial technology sector looking for deals. But Steve McLaughlin, 37, has been swimming in that pool since early 2002, when he left an eight-year stint at **Goldman, Sachs & Co.** — where he co-founded the firm's financial technology effort — to start **Financial Technology Partners LLC**, a 15-person boutique in San Francisco.

The sector, a sprawling landscape of 10,000 companies specializing in everything from financial software to capital markets technology to payroll processing, boasts such big names as SunGard, **First Data Corp.**, **Fiserv Inc.** and **Metavante Corp.**; electronic brokerages **Charles Schwab Corp.** and **E*Trade Financial Corp.**; and trading system **Liquidnet Holdings Inc.** But McLaughlin focuses mostly on the smaller companies that make up about 95% of the market. "There are a large number of smaller companies on the rise that rarely come up on the radar screen for the bulge-bracket banks, and by the time they're worth $500 million to $1 billion, we've known them for five years," McLaughlin says. Examples include Liquidnet, which FT Partners advised on a $250 million private placement in 2005, and **VeriFone Inc.** McLaughlin has known and worked with both companies since at least 2002, he says.

McLaughlin has also done some cross-border deals, including the sale of Grand Rapids, Mich.-based Lynk Systems Inc. to **Royal Bank of Scotland Group plc** and the sale of Nashville-based Verus Financial Management Inc. to the U.K.'s **Sage Group plc**, the parent of Irvine, Calif.-based Sage Software. He counts the Lynk deal as one of his successes against larger competitors: After a big investment bank tried — and failed — to sell Lynk for $170 million, FT Partners negotiated a $525 million sale by reaching out to multiple European buyers, winning a $12.5 million fee based on the higher value. "As a boutique, if you do a great job, you'll really get rewarded for that," he says. "Conversely, if you do a bad or a mediocre job, you'll get a mediocre payment."

McLaughlin recently talked to The Deal about the outlook for financial technology, the rising interest of private equity firms and hedge funds in the sector and the importance of "co-opetition" in a business that is rife with conflicts.

The Deal: *What's driving M&A in the financial technology sector?*

Steve McLaughlin: It's either a game of scale or a move to diversification.

On the one hand, I would say the driver is scale — companies wanting to be bigger and better and more cost-effective at what they do, because the market demands it and because if you don't do it, somebody else will. So for the transaction-processing-intensive businesses, it's all about scale.

The other factor, which was apparent when **Lehman** [**Brothers Inc.**] bought Townsend Analytics [Ltd.] and [**Investment Technology Group Inc.**] bought Macgregor [Group Inc.], is that you're seeing financial-services firms looking to get a competitive advantage by buying software-driven firms and integrating the delivery of both. Lehman, a big, old brokerage firm, bought Townsend Analytics and its front-end equity trading system because they want to hook clients by giving them a high-end piece of software. It's the same thing with ITG, which is really a brokerage firm that facilitates electronic trading. But they bought Macgregor, which was a brand-new move for them into a new space, order-management technology, providing order management for buy-side clients and hedge funds. In financial services, it's about differentiating your traditional offerings by offering high-tech solutions to your clients.

Who are the big consolidators in the business?

There are different consolidators in different sectors. In the payments sector, firms like First Data Corp., Fiserv, Metavante and [**Fidelity National Information Systems Inc.**] have all continued to consolidate, with the most aggressive being Fiserv and Metavante and the least aggressive being First Data.

In the securities and capital markets world, as well, all the old consolidators aren't consolidators any more. It used to be **SunGard** [**Data Systems Inc.**], **Thomson** [**Financial**], **Reuters** [**Group plc**], **Advent Software** [**Inc.**] — people with multibillion-dollar market caps that, between them, were buying a company a week. Now a lot of the deals are going elsewhere, either to big financial services firms or merging amongst themselves.

There's a point where the traditional consolidators get congested, where they have done a lot of deals and have to integrate them, which causes a lot of indigestion. SunGard is a great example of a consolidator that got an upset stomach at not being able to integrate all their new service channels. So their stock was lagging, and ultimately they had to do an LBO to realize the value of all their acquisitions. So they are, at least temporarily, largely taken off the table as a big acquirer in the sector — but I do think you'll see them return once the LBO settles in.

Many of the companies in the sector are small and private, so how do you find them?

We source them through our relationships with venture capitalists, our knowledge of the industry and from hundreds of trade publications and going to all the trade association meetings and visiting all the booths — groundswell activity where you really find out what's going on.

There have been multibillion-dollar financial technology companies started with less than $15 million of capital, so it's not a very capital-intensive business to get started in. I would say that almost every deal we've done has had a private equity, venture capital or hedge fund component to it, either as a current or future investor in our clients.

Five years ago, there were really no private equity firms that had a high degree of interest in financial technology. It has rapidly become one of the most attractive sectors for private equity firms to focus on, so we have relationships with every firm and every individual in private equity and venture capital that is interested in financial technology.

How does the prevalence of PE and VC money affect valuations in the sector?

In almost every transaction we do now, there is an equal interest and similar valuations between what private equity firms and strategic firms are willing to pay. Part of that is the scarcity of good deals. Part of it is that strategics are less aggressive these days, given the higher bar for what constitutes a successful M&A transaction. Buy-side investors have put more scrutiny around acquisitions, and if a strategic buyer is perceived to have overpaid for something in this market, their stock can take an even bigger hit than what they overpaid, hitting them with a double whammy.

What is causing the companies in the sector to seek these really large private placements?

One reason is that good private companies are resisting going public because of Sarbanes-Oxley and other headaches associated with being public. There's also a resistance from the public markets if you try to take companies public at too early a stage — equity research is dead, and block trading is harder and harder to come by, which is making small-cap stocks more illiquid and less valuable.

So a lot of companies are finding this middle ground of what I sometimes call an FPO — a final private offering or a pre-IPO round, where you're basically going out and doing something that looks and feels like an IPO from a valuation and liquidity and size perspective, but in a private context. The companies get a lot of capital at high, but still fair, valuations. They also get it quickly and easily, because capital is available out there and the hedge fund market has opened up the ability to do these kinds of deals.

So there are really two kinds of transactions in the private equity and hedge fund communities today. One type of deal is heavily shopped and heavily negotiated with very few private equity firms or venture capitalists. Those deals are highly diligenced, highly scrutinized, and tend to be private deals that take a lot longer to do.

The other kind, that's becoming more in vogue, is to put together the terms of an offering, in a detailed IPO-like prospectus, and then have a placement agent put you on a road show with, say, 50 hedge funds, and each hedge fund will take, say, between $10 million and $50 million chunks with more limited diligence, but relying on the investment bank's opinion, the management's presentation, the strength of the offering memorandum and the deal terms.

That's interesting, because the hedge funds are also big users of financial technology companies — so they want to be both clients and owners?

The financial services and technology world is rife with conflicts: with the big banks, with the buy side, with the sell side. Customers and clients are constantly doing battle and engaging in "co-opetition," cooperating but competing with each other. With a company like Liquidnet, the last thing they wanted to do was go out to a bunch of hedge funds or bulge-bracket banks and reveal the nuances of their business plan. But in a situation like **Vonage** [**Holdings Corp.**], which has no interest in selling anything to the hedge fund community, it's a no-brainer to go out to the hedge funds.

I'm interested in the structures of these private deals. Are they usually just straight offerings, or do they have complex structures?

I think investors and issuers are finding ways of creating creative structures that serve the new investor base — hedge funds. The structures are tied into the type of offering you're doing. Private equity firms have traditionally refused — you can underline "refused" — to do common stock or convertible debt because the common stock does not yield enough downside protection and the convertible debt does not have enough upside due to call features. So convertible preferred has become the investment vehicle of choice for large private equity firms and minority transactions.

On the flip side, enter the hedge fund community. They are creative, much more nimble and much less interested in doing a mind-numbingly deep level of due diligence or investing huge sums. They would rather invest smaller sums in a larger number of deals and get more diversification, and to do that they have to do less diligence by design.

In one transaction we're involved in right now, we have set the structure at a convertible preferred with a ratchet feature that quote, unquote guarantees a 35% [internal rate of return] at the time of an IPO or sale, at a minimum, prior to management or the common stock holders having any return at all. The investor is able to focus on the upside of the deal, and can make much quicker investment decisions, and can make sure that if the company doesn't perform, it's management that's taking the hit, not them.

If the company achieves its objectives, it gets a higher effective price. But if the company does not achieve its objectives, it gets a much lower valuation, because this 35% ratchet kicks in. FT Partners actually invented this structure. No one has used this before that we know of.

How do you compete with the larger investment banks?

Every boutique that wins a piece of business in a large deal faces an element where they cannot provide full service. We are not full-service investment bankers in the broad sense of the term. We are providing the highest level of strategic advice, but we don't do [foreign exchange] trading, we don't do equity research, we don't lead manage multibillion-dollar IPOs in China. We've competed with the large banks, worked with them and been providing dealflow to large investment banks who compete for parts of the business we don't handle 100%.

But we are able to gain a level of prominence with the CEOs of these companies, then we end up either winning a transaction or being able to direct pieces of a transaction to certain other firms. You need one core, central independent adviser who can help you choose the best of the best for whatever execution you decide to take on.

First and foremost, we're winning many very lucrative deals. We have five core clients that are in the multibillion-dollar market-value range, so we're winning some large deals away from the investment banks.

Second, we're working with the large banks on deals that we would have never had access to in the past. For instance, we are co-managing a multi-hundred-million-dollar private placement with a large investment bank, UBS.

And we are happy to work hand-in-hand with the large investment banks, where we bring the industry knowledge and they provide the juice for the distribution, because they have deeper hedge fund relationships, or they bring an international component to the deal, where we're less strong.

So it should encourage the big banks to work with the boutiques like us, to understand that they are in co-opetition with the boutiques. It would behoove the big banks to build a healthy relationship with the boutiques so that they can both benefit from each other.