BDO

PRIVATE EQUITY
PERSPECTIVES
PODCAST

EPISODE 18:
FUTURE OF FINTECH: PE'S DEALMAKING OUTLOOK FOR 2020

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

TOPICS DISCUSSED INCLUDE:

INTRODUCTION

Todd: Hello, and welcome to another episode of BDO's Private Equity PErspectives Podcast. I'm Todd Kinney, National Relationship Director with BDO's Private Equity practice, based here in New York City. I'm really excited to have two special guests with me today to talk about the landscape of PE and VC investments, in financial services, and really strategies for value creation, in general. First, we have Peter Nesvold, Chief Operating Officer, Financial Services Investment Banking at Raymond James. Great to have you on the show today, Peter.

Peter: Thanks for having me.

Todd: Yes. Also, I'm thrilled to have Sachin Sarnobat, who is a Managing Director at Atalaya Capital. Thanks for taking time to be on the program, Sachin.

Sachin: Thank you, Todd. Excited to be here.

INTRODUCTORY QUESTIONS

Todd: Awesome. Let's jump into it. I guess, Peter, I'll throw the first question to you. Can you tell us about your role at Raymond James and also about-- I think it's very unique— we haven't had a lot of folks on the Podcast that have written books, so maybe you can talk about some of the books you've written on M&A as well.

Peter: You bet. So, I think a lot of people think of Raymond James primarily as a wealth management firm, but we have a sizeable mid-market investment bank as well. Roughly 350 investment bankers who had advised on more than 600 mandates since 2015. So, as the Chief Operating Officers of Financial Services Investment Banking, I oversee roughly 50 investment bankers in seven cities. We cover depositories, spec fin, insurance, asset wealth management. We rank usually in the top three in each of those categories. In terms of the books, it certainly is a labor of love, so I've co-authored four books in the art of M&A series. The books average about 500 pages each, so if you have insomnia, I highly recommend them to you. And for the past five years, I've been an adjunct professor at Fordham University's Gabelli School of Business, where I teach M&A to undergrads and MBAs as well.

Todd: Awesome. Very impressive. I'm sure you will have some good insights for us as we dig into things. So, Sachin, maybe you could tell our listeners about your work at Atalaya, as well as the fascinating patent you earned in data mining and how you feel that relates to the financial services industry.

Sachin: Thank you, Todd. Let me start off with Atalaya. Atalaya is an alternative investment manager that focuses on making private credit and special opportunity investments across corporate, real estate and specialty finance. Our firm has focused on investing in credit-oriented assets for over 13 years now. We create credit assets, we buy credit assets and we finance credit assets, all with a focus on the fundamental characteristics of the underlying assets. The firm spends a lot of time in financial services because it's broad and it's fragmented. To give you a sense of the market size, there are tens of thousands of companies in the sector which have over $1.5 trillion in credit assets spanning consumer, commercial and real estate financing. Given the size and scope, we believe that the financial services space represents to us an all-weather opportunity set. These companies produce a high volume of credit-oriented assets that need to be financed and we typically look for opportunities with companies that need our structuring technology, our industry expertise, and especially access to scalable capital solutions. Speaking of the patent, I began my career focused on analyzing consumer behavior and trying to predict consumer credit risk using non-linear models with both quantitative and textual data. That type of predictive modeling was at the cutting edge almost 15 years ago, but now is known as artificial intelligence of big data. You might be surprised to hear this, but the type of predictive analytics that I was working on back then haven't really changed over the intervening years although the technology and the models themselves have become more robust because of the proliferation of a lot more data sources. The volume of data that's now available to predict what consumers will do is quite amazing, and I think this theme of big data seems to have contributed significantly to the fintech evolution of the banking industry.

Todd: Pretty fascinating. As I guess you could imagine, I think you're our first patent-holder on the podcast.

Sachin: Honored to be here.

FINANCIAL SERVICES INDUSTRY UPDATE / FINTECH

Todd: So, we have a patent-holder and an author. Fantastic. So, going further on the connection, why don't we explore the world of fintech? Peter, I'll throw this one to you. Where are we now compared to where we were five years ago?

Peter: Yeah, that's a good question. I think what we're starting to see is a convergence of the so-called pure play fintech platforms and traditional financial institutions. And by that, what I mean is a lot of the innovation that we saw the first half of this decade. So, whether that was new technology, new business models, we're now seeing that become integrated across the industry. So, Robin Hood is a really good example. Robin Hood is only five years old, founded in 2014. And the idea of zero commissions for stock trades, at that time, was quite revolutionary. How can this company possibly make money? Some of us, of a certain age, might even remember an SNL (Saturday Night Live) skit from the 90s called The Change Bank. And all the bank did was make change. How are they going to make money? Through volume, right? And so, I think, in the early days, Robin Hood was quite revolutionary because the business model was not very clear. Today, zero commissions are now the industry norm. Another good example would be robo-advisors. So, they're well over a hundred independent robo-advisors five years ago. As the use case was being proven in robo-advisors, we saw Schwab and then Vanguard jump in, and it really catapulted that particular market segment, and they leapfrogged the independents. So, what's fascinating about this is that these trends are not new. You could actually argue that there's this sort of rolling five-year innovation wave in fintech before things go mainstream. The best example I can think of is online banking. The pioneers of online banking were really these internet-only banks like Netbank and Telebank, companies you might have to go to Wikipedia, frankly, to find the names of at this point, and that was in the early 1990s. Five years later, when BofA (Bank of America) decided to get into online banking, well, they catapulted those independents. And now, online banking is clearly pervasive. So, I guess it's a long way of saying that today's fintech is really tomorrow's tech-enabled solution.

Todd: Yeah, makes a lot of sense. Sachin, I'll kick it over to you. Maybe you could tell our listeners where you think fintech is headed.

Sachin: That's a good question, Todd, and I think, for that, it's important to take a step back and think about the entomology of fintech –fin and tech. We see these as two parallel, long-standing, stand-alone industries, each with their own secular trends that have morphed together to create this fintech revolution. This has partially been led by bank disintermediation which has been taking place for a couple of decades now. Banks are no longer the only distribution channel nor are they the preferred underwriting standard. Local banks seem to be losing a little bit of their historical, multiproduct relevance with their borrowers, and historically, borrowers approached local banks for many products which allowed banks to use the high-margin products to subsidize the distribution costs. Today, technology seems to be chipping away at most, if not all, of these high-margin products. This seems to be where the second part of the fintech evolution is happening. Technology has enabled localized data capture and remote underwriting and servicing. Thereby encroaching on one of the critical places in the value chain where we thought the banks actually did a pretty good job. Both of these trends have allowed disruptive tech-enabled business models to replace traditional banks. For example, consumer finance, we think, is one of the largest segments where such disruption has given rise to a plethora of the subscale originators focused on hyper-niche but very profitable consumer seconds. The fintech landscape has generated cross-sectional interest from a variety of investors ranging from venture capital and growth equity firms to strategic investors and, of course, lenders. In reality, I think firms with deep expertise across both the fin and the tech are going to be the ones that are going to be successful in the longer term.

FINANCIAL SERVICES MARKET ENVIRONMENT

Todd: Excellent. Lots of good content and points for our listeners to think about on fintech. Let's move on to our next topic. I'd like to ask Peter his thoughts really on some of the factors driving PE and VC deal activity in financial services. Actually, according to BDO's upcoming survey of PE fund managers and VC professionals, it looks like the financial services sector was cited as one of the top industries likely to experience increasing deal activity in the year ahead. So, Peter, I guess the question for you is, what do you think are some of the factors that are really contributing to this?

Peter: Yeah, we can definitely attest to that, at least anecdotally, in terms of the amount of private equity interest in financial services. As FIG (Financial Institutions Group) bankers, our group is absolutely running into more and more generalist private equity firms looking to deploy capital into the space. And that is an enormous difference versus five years ago or ten years ago. At that time financial services was really just the domain of specialist sponsors, J.C. Flowers, if you remember from the crisis days, firms like Aquiline. There were probably a dozen PE shops that really focused on FIG at least back then. Today we track more than 200 private equity firms that have reached out to our department looking for deal flow. And I think a couple of things have changed. Coming out of the financial crisis a lot of the deals were very much balance sheet driven. It was about stabilizing the capital structure of large financial institutions and you really had to be an expert. You had to have deep resources to do that and probably more importantly scale was really of paramount importance. Sort of mid this decade we saw a pivot more towards asset light businesses in financial services. That's where the interest was going more business services-oriented companies. So, we're not investing in a bank, we're investing in a tech-enabled specialty finance platform that originates in factors receivables. We certainly have seen tremendous interest in the wealth management space as well. Enormously fragmented, almost 14,000 independent firms in the industry. There are roughly 3,700 that have at least $1 billion in assets, benefits of scale economies. There are now lenders that are willing to put leverage on these things and the demographics of the owners, the principals of wealth management firms have really hit a tipping point where consolidation's going to be forced, frankly, just due to their own life cycles. So yes, I would say we certainly are seeing more PE interest in financial services.

Todd: Yeah. Lots of good points. As are we, for sure. Sachin, I'll turn to you now. I'm really interested in hearing about private credit strategies. Can you talk a bit about your experience in investing in the area?

Sachin: Of course. Thanks, Todd. Private credit in our view is a direct consequence of the earlier mentioned bank disintermediation trend which has only accelerated over the last few years. Since the global financial crisis of 2008, direct private credit investments outside of the traditional banking system have grown significantly. Both regulation and competition have added pressure to the traditional regional banking model to consolidate and focus on larger borrowers which are typically easier to underwrite and service than smaller borrowers. This has left smaller borrowers with much reduced access to bank financing because there's a higher degree of resources required to diligence and monitor these borrowers. While private credit funds have emerged as a capital source for companies that these banks are no longer financing, the vast majority of such private debt funds seem to focus on private equity sponsor lending. Consequently, middle market companies that do not have the backing of a private equity sponsor or fit into a predefined mold, find it a little bit harder to access these pools of private credit. At Atalaya, we actually like these mid-market borrowers and are excited to work closely with founder-led management teams. We typically offer transformational capital to achieve near-term goals. Oftentimes, founders need a lot more than just access to capital. They also benefit from a collaborative institutional partner to help them for a sale process or the next capital raise. Typically, we will design a financing plan with the borrowers business objectives in mind. One that enables the company to invest new capital efficiently. Both transformation and turbulence may be driven by rapid growth, may be evolving business plans, or even distress.

One of Atalaya's approach to investing is to help these borrowers successfully navigate these transformative but turbulent periods for their business. When a business is at such a strategic inflection point whether that's reached by adding infrastructure for growth, operationally intensive execution, business plan changes, it's often easier to rely on one sophisticated investor who is aligned with the overall success of the business.

COFFEE BREAK WITH BDO'S KEITH MCGOWAN

Todd: Great. Appreciate the insights on the credit side. That's very helpful. At this point let's jump into our Coffee Break guest. Today we have Keith McGowan, who's the National Practice Leader for BDO's Asset Management practice. Keith is based here in the New York City office with me. Let's hear from him now.

Keith: Thanks, Todd. My name is Keith McGowan, and I am BDO's Asset Management Industry Leader. Today, I'm here to talk about the role of fintech as it relates to value creation in traditional asset management.

The rise of fintech companies and solutions over the last five years has led to a completely new and transformed financial services landscape. Catalysts such as changing customer expectations, cut-throat competition, a squeeze on fees, increasing regulatory complexity, and pressure to streamline operations by driving the push for reinvention and innovation in the financial services sector.

The asset management industry is not immune to this disruption. One example is the rise of robo advisors both competing and collaborating with RIAs and broker-dealers by providing financial and investment management services online and via mobile devices with often moderate to minimal human intervention. Based on complex algorithms these digital platforms demonstrate how fintech is living up to its name as a disruptor by shifting the roles of traditional fund managers and financial advisors as well as altering investment flows. It raises the stakes for traditional RIAs to be successful.

As technologies like these and others like the Internet of Things, blockchain, artificial intelligence, and ecosystems that incorporate elements of each give rise to new business models and solutions, it's critical to understand how with technology in flux from the type, size, and capabilities of fintech standalone to new fintech applications what this impact will be on client relationships, expectations, and introducing new competitive advantages.

Most financial services companies recognize that fintech needs to be at the heart of their strategy going forward. However, according to BDO's 2019 Middle Market Digital Transformation Survey, while 68% of financial services companies have developed a digital transformation strategy, only 14% of them are actually in the process of implementation, highlighting a wide gap between good intentions and reality.

Despite its unpredictability and challenges, digital transformation has proven to generate high ROI for organizations. Fintech's demonstrable financial benefits tend to outweigh most of the major challenges to implementing fintech strategies. In fact, the same survey found that 62% of all financial services organizations saw their revenue increase significantly by one to nine percent due to digital investments. While 24% of upper, middle market organizations reported a 10% or greater revenue increase due to digital investments.

Overall, fintech can be perceived as a positive force and partner providing capabilities to streamline processes and optimize efficiency rather than the enemy. For example, when implemented effectively, data-driven strategies can help fund managers make better investments. With regard to private equity, there's a huge opportunity for operational value creation either through digitalization strategies or fintech add-ons. That's reflected in BDO's new 2020 Private Capital Outlook Survey, which has both venture capital fund managers and private equity fund managers ranking financial services as one of the top three sectors expected to see an increase in deal activity over the next 12 months.

Thank you for listening to today's Coffee Break. I am Keith McGowan, and I'm sending this back to you, Todd.

Todd: Thanks for your insights, Keith. So, let's jump back in our chat today with our guests, Sachin Sarnobat and Peter Nesvold. I guess Sachin the next topic is for you – esoteric assets, really which have always existed. Seem to gain traction before the 2008 financial crisis but now have really seemingly phased out over time due to struggles in infrastructure to capitalize on them. I guess the question is Sachin, are you starting to see these securities become more popular?

ESOTERIC ASSETS

Sachin: Thanks, Todd. It's interesting. I love the word; esoteric assets. I ask myself what are esoteric assets?

Todd: So, do I. [laughter]

Sachin: Historically, these esoteric assets have comprised of financing what I call off the run assets or maybe receivables from rental cars, subprime consumer loans, aircraft, litigation finance, cat bonds, and many other similar asset classes that we use every single day. While these products are used by a very large portion of the overall economy, they themselves are highly bespoke, often nonhomogeneous, and need active servicing to maximize value that's embedded in them. Asset-based securitization markets that you refer to, always have an appetite for these large diverse pools of assets at highly attractive advance rates, but still offer a reasonable premium to other similarly rated tranches. At Atalaya, we've typically invested in diversified pools of these esoteric assets that are not efficient or subscale for either banks, and most definitely the securitization markets. These situations typically involve a significant level of industry expertise to conduct thorough due diligence, structure transactions, appropriately have access to backup servicing relationships, and most importantly, scalable pool of capital. There are natural barriers to entry for investing in these assets, because anything that's not cookie-cutter is going to be less efficient for either banks or the securitization markets. Borrowers seeking investors or lenders for such esoteric investments typically only find a few select firms with the capabilities and the appetites to evaluate these opportunities. So, to sum it up, I think the demand keeps going up, but we only have a small pool of investors that the borrowers can actually go to.

POST-CRISIS RISE IN PE ACTIVITY

Todd: All right. Pretty fascinating stuff, providing some clarity for the host here. So, Peter, I know you're focused on the asset and wealth management space. Perhaps you could tell our listeners what you think are some of the drivers behind the asset and wealth management explosion in PE activity.

Peter: Yeah, so yeah, as I mentioned a short while ago, there are over 13,000 independently registered SEC financial advisory firms in the industry. I think at one time, a lot of investors thought of these firms as being more or less levered plays on the equity markets. So, AUM goes up as the financial markets go up, so revenues go up, earnings go up, but if the market rolls over, would we see that same shift to the downside. I guess the one benefit coming out of the financial crisis is that these financial models were really tested to their extremes. And what we found was, the best-managed wealth management firms, let's say top quartile, actually grew during the financial crisis. Investors took money from underperforming managers, or managers where they had lost faith and conviction, and put it in the hands of managers that they thought could do a more professional job. And so, this idea that the industry was a levered play on the equity markets was really dissolved. We've seen at least a half a dozen sponsor-backed consolidators enter the market. We've seen Focus Financial go public, and my prediction is within 24 months, we'll see a couple of other of these financial sponsor-owned platforms also hit the IPO market.

Todd: Awesome. Well, I really appreciate your collected take on the market and where it's headed. So, Sachin Sarnobat with Atalaya Capital and Peter Nesvold, with Raymond James--can't thank you enough. I know our listeners are going to enjoy hearing your insights. We value the BDO relationship with both of your firms, so thank you so much. I know you guys are busy guys. So, thanks for being here today.

Sachin: Thank you, Todd.

Peter: Thank you.

Todd: To our listeners, thanks so much for tuning in. If you haven't already, we'd love for you to subscribe, rate, and leave a review of the show on iTunes. Until next time, this is BDO's Private Equity PErspectives.

If you enjoyed the show, please visit **iTunes** to subscribe, rate, and leave a review. Join us next time for another edition of Private Equity PErspectives, and listen to the full series **here**.

People who know Private Equity, know BDO.

www.bdo.com/**privateequity**

CONTACT:

SCOTT HENDON
Private Equity Practice Leader
214-665-0750 / shendon@bdo.com

TODD KINNEY
Director, Private Equity Industry
212-885-7485 / tkinney@bdo.com