Key Takeaways

Skadden

Fintech in Focus

Trends and Key Issues in Fintech M&A

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In a webinar held on 10 December 2020, Skadden partners **Sonia Nijjar**, **Simon Toms** and **Ingrid Vandenborre** were joined by Charles River Associates (CRA) Senior Adviser and Deputy Chair of the Bank of England's Enforcement Decision Making Committee **Philip Marsden** and CRA Vice President **Oliver Latham** to discuss fintech M&A trends and developments, including:

- the fintech industry's response to recent deals;
- the effect of regulatory developments on market dynamics, competition and innovation;
- the key deal terms in negotiations of fintech M&A;
- the role of antitrust regulators in transactions involving fintech; and
- the economic analysis that underpins the antitrust assessment of fintech M&A.

Industry Developments

Mr. Toms introduced the webinar by recalling that fintech M&A activity produced 439 transactions and a disclosed transaction value of over $130 billion in 2019. This uptick was the continuation of a trend. Ms. Nijjar observed that the increase in fintech activity continued in 2020. After the onset of the COVID-19 pandemic, Ms. Nijjar noted that the world saw a huge shift in consumer behavior away from the traditional brick-and-mortar model, which has accelerated the growth and proliferation of fintech and fintech M&A. Ms. Nijjar forecasted that the size and pace of fintech deals would continue to increase in the coming years as people's behaviors continue to change. In addition, the pandemic did not affect the factors that previously made the space attractive, such as the lean operating model of fintechs. In a nutshell, the maturing of the fintech industry, growth potential and resiliency have resulted in an active fintech M&A market in the past year.

Ms. Nijjar observed that fintech M&A follows the key technologies at any given time. Currently, the main areas of interest are distributed ledger technology, blockchain, open banking APIs and digital banking, artificial intelligence, machine learning, peer-to-peer technology and regulatory technology. The payments sector has also been very active this year. U.K. deals involving payment services in the first quarter of 2020 alone exceeded the total number of deals in 2019. Although deal sizes were relatively low-value, this uptick highlights how unique challenges presented by the pandemic have propelled this sector.

There are a number of active players in this space. For fintech startups, M&A represents an opportunity to advance their capabilities and expand into adjacent areas or geographies as their ventures mature and innovate. Banks and other established financial institutions initially sought to develop fintech solutions in-house or through partnerships — as fintech becomes more central to their business strategies, M&A has become an important tool in building their fintech capabilities. Highlighted deals include American Express's acquisition of Kabbage and Bank of Montreal's acquisition of Clearpool. Certain nonfinancial services also are active in the M&A space: From e-commerce platforms to health and fitness tech companies, nonfinancial service providers are finding new ways to leverage their consumers' data to offer personalized financial products and services. Finally, PE investment in fintech is expected to continue, as the factors that make the space attractive, including high growth and recurring revenue, persist. By and large, as well-capitalized businesses and investors seek to take advantage of their strength during this time to make solid acquisitions, fintech will see continued adoption, growth and consolidation in the near term benefitting from the contractual, recurring-revenue-based business models of many fintech companies, which provide steady and high-visibility revenue streams.

Regulatory Developments

Dr. Marsden noted that the fintech space is a rare example where regulators have acted as facilitators of competition and innovation in the market. Both the Revised Payment Services Directive (PSD2) and the Open Banking Implementation Entity (OBIE) have accelerated fintech adoption in the U.K., improving third parties' access to data and fostering interoperability. These changes were able to address information asymmetries in the market and create a more competitive small-and-medium-sized-enterprises lending and retail banking market.

Discussing the current state of play of regulatory interventions in the fintech space, Dr. Marsden insisted that regulatory intervention was not outcome-based but rather aimed at furthering engagement with data held by incumbents. The Financial Conduct Authority (FCA) working group is hoping to open up new areas ("open finance"), namely cross-fertilizing the regulatory model of open banking to other data-rich markets where the government holds a lot of data (such as energy, telecoms and pensions), provided that the necessary guardrails exist. Dr. Marsden recognized the knowledge gaps on the part of regulators as another reason for regulators not to mandate market outcomes, and instead leave it to the market to identify opportunities. Turning the discussion to future regulatory developments, Dr. Marsden noted that regulatory oversight would be necessary and critical with regards to the disclosure of sensitive data, such as health care data. He posited that regulators would need to rely on more than just consumer consent in order to guarantee the safety and security of the data.

Mr. Toms asked whether the slow takeoff of open banking in the past should be attributed to consumer reluctance or rather to financial institutions' apathy and the lack of regulatory incentives. Dr. Marsden replied that consumers are not likely to switch to or adopt new solutions, and thus the relevant regulators need to open up new areas tapping the potential of data, in order to nudge the market to act quicker and promote new entrants on the markets. Guidance to the industry on the part of regulators would be a welcome development to provide a sense of security on what is permissible in the market. Cooperation between financial, competition and data protection regulators (*e.g.*, the Treasury, the Bank of England, the FCA and the Competition and Markets Authority (CMA) in the U.K.) is key to further develop the sector and provide a blueprint that can be used by other countries.

M&A

Ms. Nijjar provided an overview of the key deal terms in fintech M&A, underscoring that at present parties are looking to allocate the risk of the pandemic and its negative impact on the target business.

The "material adverse change" provision now often explicitly refers to public health events. In deals signed up after the start of the COVID-19 pandemic, sellers often have negotiated to add the impact of COVID-19 on the target company as an exclusion to a material adverse change provision. On the other hand, buyers are seeking additional representations and warranties relating to the target business's contingency planning, emergency protocols and the like. A related point of negotiation is what sellers need to disclose about the potential impact of COVID-19 on the target company's business to ensure adequate defences in the event of a claim — one could see the virus impacting several of the target company's representations, including the status of material contracts or the accuracy of the target company's financial statements.

Mr. Toms asked whether the pandemic has affected pricing and payment terms. Ms. Nijjar observed that in a downturn we usually expect to see fewer cash deals (where the impact of the pandemic can make valuations challenging) and more stock-for-stock deals. The latter can be easier to price: If share prices of both companies have declined by a similar amount, then their relative values remain the same for purposes of negotiating an exchange ratio. One mechanism that can be used to protect buyers from sudden market fluctuations is a fixed-dollar value collar to set the exchange ratio.

Ms. Nijjar noticed an uptick in the use of post-closing purchase price adjustment mechanics in private deals, where closing considerations are subject to post-closing adjustments based on the target's closing cash, indebtedness, and net working capital, with a customary review period and dispute resolution mechanics. This mechanism has been prevalent in 2020 to ensure the purchase price paid reflects the state of the target company's business at the time of closing (including any changes in the value of the target's business due to the effects of the virus).

In addition to pandemic-related deal terms, Ms. Nijjar noted that fintech M&A includes specific provisions such as escrow arrangements to satisfy indemnification claims and any purchase price true up in private deals. In addition to, or in lieu of, an indemnity escrow, some buyers purchase representations and warranties insurance. In cases where the continued success of the target business is expected to heavily depend on the retention of the target company founder and other key employees, the buyer often requires the target's key persons to remain employed and not repudiate or rescind their offer letters with the buyer. Ms. Nijjar stressed that regulatory issues are critical to fintech deals.

Finally, Ms. Nijjar observed that special purpose acquisition companies (SPACs) have emerged as one of the most popular investment vehicles in 2020. She does not expect SPACs to replace M&A, but we will see them being utilized by fintech companies who want to go public instead of consolidate.

Antitrust

Discussing the antitrust aspect of M&A deals, Ms. Vandenborre agreed that there had been heightened scrutiny of fintech deals from competition authorities around the world (*e.g.*,the now abandoned Visa/Plaid, PayPal/Honey, PayPal/iZettle, Mastercard/Nets and Worldline/Ingenico). The U.K. CMA has reviewed many of these deals and has asserted itself as a key competition review agency for fintech deals.

Ms. Vandenborre noted that CMA review of fintech deals is at least in part due to its "share of supply" jurisdictional test (25%), which the CMA uses as a flexible "gateway" to review transactions involving target entities with limited turnover. Most other jurisdictions' competence is limited by minimum target revenue thresholds that start-up fintech entities typically would not meet. She identified Germany and Austria as other relevant jurisdictions, as they are able to review transactions on the basis of the transaction value. She explained that fintech deals thus share with other "tech" deals the nature and scope of antitrust review, focused in jurisdictions with share-based or transaction value-based thresholds. She explained that the "fin" aspect, which makes these reviews different from other tech deal review, can lead to the involvement of a sector regulator that often can have a wider perspective of the competitive landscape and can introduce a policy angle that may impact the review of these transactions.

Ms. Vandenborre explained that the CMA in particular has been very vigilant. The CMA Mergers Intelligence Unit actively monitors the market for cases that may fall within its jurisdiction; this was made even easier at the end of 2020, as companies now may need to notify transactions both to the European Commission and the CMA, and in light of the proposed guidelines on jurisdiction issued recently by the CMA. She also noted that the CMA routinely issues initial enforcement orders to prevent the completion of the transaction prior to the end of its investigation. Although the parties have some room to negotiate the IEOs, they often are far-reaching compared to traditional gun-jumping rules applicable in most jurisdictions and go beyond the companies' U.K. operations to cover their global operations.

Mr. Toms asked about the principal antitrust hurdles. Ms. Vandenborre stressed the flexible basis for the CMA to assert jurisdiction based on share of supply as an important challenge, as it effectively requires an assessment on the merits very early on in the review of a potential transaction, thereby reversing the normal sequence of review. In addition, the CMA has adopted extensive and broad approaches to identify what may constitute a relevant frame of reference to calculate a share of supply. Ms. Vandenborre noted that this reduces legal certainty for clients in devising the terms for their agreement (*e.g*,, the jurisdictions that should be included in the list of conditions to closing). Taking PayPal/iZettle and Visa/Plaid as examples, Ms. Vandenborre explained that the CMA had defined the market in a broad way to support jurisdiction. However, this approach is not necessarily limited to the U.K.. Along the same lines, in PayPal/Honey the German regulator assumed jurisdiction based on transaction-value threshold, finding that Honey's economic and competitive potential is not reflected in its low turnover and focusing on the multisided nature of the platform.

Ms. Vandenborre also noted the novel theories of harm that can impact regulatory review in fintech deals in particular. Antitrust agencies are keen on exercising a fastidious assessment in order to capture business strategies that can be conceptualized as "killer acquisitions" or "reverse killer acquisitions," Ms. Vandenborre said. In this regard, a primary consideration is the valuation analysis as a corollary of a perceived defensive acquisition. The identification of a deal premium, discussed and explained in internal documents for example, can be a potential red flag for indicating a "killer acquisition" intention. Another key aspect of antitrust review in tech M&A is the increasing emphasis on the notion of "potential" or "nascent" competition, and the deployment of dynamic counterfactuals, which extrapolate alternative future entry strategies from both the side of the buyer and the side of the target. Because of the forward-looking nature of these theories of harm and the lack of actual economic evidence that can support or contradict them with sufficient certainty, competitive review of these developments tend to focus on an analysis of incentives, often based on company documents. Ms. Vandenborre said this also is something fintech deals have in common with all "tech" deal reviews.

Commenting on antitrust developments in the fintech sector in the U.S., Ms. Vandenborre acknowledged that there also is vivid interest in fintech across the pond, as demonstrated by both regulatory developments and decisional practice. The recent reorganization of DOJ's Antitrust Division with the creation of a section devoted to Financial Services, Fintech and Banking, along with the increasing scrutiny of a number of recent fintech deals such as Mastercard/Finicity, Visa/Plaid and Intuit/Credit Karma, support this statement.

Economic Assessment

Mr. Latham discussed the economic approach in assessing potential competition issues in fintech cases. Transactions that previously would have been seen as purely complementary or conglomerate in nature and presumptively procompetitive are now treated with scepticism and concerns that they may be masking dynamic competitive harms. While consumer-facing tech platforms have been the authorities' main focus, fintech and payments companies are not immune. By comparing the CMA's analysis in the Mastercard/VocaLink transaction in 2017 with its analysis in more recent deals such as Visa/Plaid, Mr. Latham noted a switch from static to dynamic considerations.

These potential competition issues take economists out of their comfort zone, as familiar tools of diversion ratios, price pressure indices, surveys and merger simulation are unsuitable in nascent markets (particularly when services are free or subject to penetration prices). Instead one is left with a murkier world of internal documents and market forecasts. Mr. Latham discussed five parameters that economists will be looking for in a potential "reverse killer acquisition" scenario:

- How committed was the purchaser to enter the space organically? This will lead to a detailed assessment of the economic incentives of the buyer, examining the likelihood of organic entry and the overall strategic rationale for the deal.
- How unique is the target firm? Reverse killer acquisition concerns only really make sense if the purchaser's entry would materially increase the level of competition without the transaction. This is more likely if the target firm is unique or faces weak competition. Authorities in Europe and the U.S. have had different interpretations of the uniqueness of specific fintechs.
- Are the purchaser's existing assets well-suited to enable organic entry? In order for concerns to arise, it must be that the purchaser was a well-placed entrant in its own right. For consumer-facing tech platforms with large user bases, the regulators often will assume that this is the case, but this may be less clear in a fintech context where start-ups may have niche technical expertise or entry is made difficult by regulatory constraints.
- Is there a positive efficiency story around the deal? Are consumer benefits brought to market more quickly or effectively as a result of the transaction? This is important in any regulatory review but becomes particularly important in deals involving tech or payments.
- How will the deal valuation be interpreted by the regulators? Agencies will examine in detail valuation materials to identify any unexplainable premiums that cannot be justified by the synergies put forward.

So what does all this mean for practical planning? Mr. Latham suggested that one needs to be both careful and credible. When it comes to being careful, one should "show ones work" when it comes to decisions or reasoning that make potential competition concerns less likely — if the purchaser has ruled out an organic build at an early stage, then it is a good idea to make sure this is well-documented and explained; if organic entry would involve long timelines or skills/expertise that are not currently within the organization, or if there are regulatory-compliance issues that would be a nightmare to resolve, then this is important to document. On the credibility point, one must recognize that agencies' first reaction will be to roll their eyes at the notion that a giant incumbent cannot replicate something put together by a small start-up with less resources. Similarly, parties need to set out an economic rationale for the transaction that is consistent with the valuation and internal documents.

Our next Fintech webinar will discuss the impact of the Biden administration on the industry. Please look out for further details.