COMMENTARY

April 15, 2016

Dear clients and colleagues,

From Amazon to Netflix to Uber, technology and innovation have bred new business models that have rapidly displaced companies that seemed to have strong competitive advantages but failed to anticipate and respond to the threat of new entrants.

One industry that has an outsized influence in the world economy and has enjoyed oligopoly-like profits in the last decades is banking. Banking has an impressive record of weathering storms and adapting to innovation, such as the ATM, telephone banking and the internet. So the growth of the "de-banked" consumer, someone who doesn't need a bank at all, may be viewed with skepticism. However, this time, it may be different.

One of banks' traditional competitive advantages has been a lower cost of funds. However, with interest rates at record lows and even negative, that advantage has eroded or even disappeared. Today, companies raise more money via capital markets than through bank borrowings. For small businesses and individuals, peer-to-peer lending (P2P) is growing exponentially.

Another traditional advantage banks have had until recently is a privileged access to customers. But no longer as technology and re-regulation have eroded this advantage.

The question is: How much damage will FinTech companies do to the banking industry?

FinTech is a widely used term. It encompasses the broader use of technology in the financial services industry, from front-end consumer products, such as peer-to-peer lending or internet banking, to new paradigms such as the Bitcoin. Over US$15 billion was invested in small FinTech companies in 2015 alone.

Finance as an industry is very vulnerable to disruption. Like publishing or music, there are no concrete goods. Regulations and data security have slowed the progress of FinTech companies until now, but this is only a temporary reprieve.

Are Banks afraid?

"If you can't beat 'em, join 'em". That was a comment by CIBC CEO Victor Dodig last year in a speech. RBC boss Dave McKay has declared a number of times that banks are on a "collision course" with offerings like Apple Pay. JP Morgan CEO Jamie Dimon warned investors in his 2015 annual letter to shareholders: "Silicon Valley is coming". "There are hundreds of startups with a lot of brains and money working on various alternatives to traditional banking".

In addition to the threats of new, small venture-capital funded entrants alluded to by Dimon, firms like Google, Apple, PayPal or Alibaba are well capitalized and may have a superior understanding of technologies and customer preferences.

Finally, we are also seeing many new independent aggregators, such as Moneysupermaket.com or Virgin Money, that are positioning themselves as the cheapest providers of best-of-breed products.

The danger for banks is not that non-banks could replicate their integrated business model, but rather that they could undermine what has traditionally been a safe source of profitability.

Banks need to adapt quickly to respond to these challenges. How? Some banks may decide to focus on fewer products where they can leverage their reputation and distribution network. Other banks may focus on franchising a smaller customer base and cross-sell. Whatever the chosen strategy, they will need better tools to analyze, reach and service their customers.

Financials is the largest sector in the MSCI World Index (large companies) at 20%. Certainly a stressful level for investors given the declining returns and increased risks faced by the industry.

For us, banks are 6% of the MSCI World Small Cap Index and our Global portfolio has 3.5% invested in banks.

How will we take advantage of the upcoming FinTech disruption?

As mentioned earlier, banks that are focused and have a privileged relationship with fewer but more loyal customers should fare better. We currently own two banks in our global portfolio; UMB Financial (UMB US), a century old bank that we profiled in June last year, and Customers Bank (CUBI US). Both are very focused in terms of products, geography and clients and have outgrown the industry.

We also own a number of companies that will benefit from the disruption brought on by technology and regulation. Nice Systems (NICE US) is a global provider of solutions for perfecting the customer experience (call center and interaction), protecting people and assets and fighting financial crime (world leader in compliance and anti-money laundering). A true big-data company.

Another company in the portfolio is ACI Worldwide (ACIW US), a leading payment solutions company providing electronic banking and payment solutions to more than 5,000 financial institutions, retailers, billers and processors around the world. Eighteen of the world's top 20 global banks and 67 of the world's top 100 global banks use ACI for payment solutions. ACI software enables $13 trillion in payments each day.

ACI Worldwide (ACIW US - $20.34)
www.aciworldwide.com

Business Overview
Founded in 1975 and headquartered in Naples, Florida, ACI is a provider of electronic payment (EP) and transaction banking solutions to over 5,600 customers in 80 countries.

Its software facilitates over 125 billion consumer transactions per year, one-third of all domestic SWIFT transactions and two-thirds of all Fed wires. Its products are used for retail payments, online banking, bill payment and collections, wholesale payments and fraud prevention.

Target Market
The market for EP and transaction banking solutions is US$20B and fragmented. According to IDC, the market is growing at 10% annually. The opportunity ahead is still vast. Cash transactions still represent $11 trillion globally according to Visa. Another opportunity is financial inclusion. There are about 2.5 billion under-banked people across the globe, 1.7 billion of these have access to a mobile phone. Finally, over 50% of the products banks use run on outdated software developed internally in the 1970s and 1980s.

Competition
Fundtech; Bottomline; Fiserv Inc.; BrightPoint, Inc.; First Data; Broadridge Financial; Intuit; etc.

Competitive advantages
Software designed for “Five nines” availability.
Universal payment solution.
Customers: 17 of the 20 top banks, 300 of the most important global retailers.

Growth strategy
Customer franchising: On average customers use less than 3 ACI products; over 20 are available.

Risks
Poor execution.

Market Data
Market Cap U$2.4B, Net Debt U$836M, P/E (2017) 28x (goodwill amortization), ev/sales (2017) 3.1x, ev/ebitda (2017) 11.8x. Earnings growth (17/16): 16% (18/17): 68%.

Have a nice week.

The Global Alpha Team