Executive Insights

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Financial Services Regulation: Four Investment Opportunities

The swath of regulation in the financial services industry, in particular following the global crisis of 2008-2009, has created significant business opportunities.

Four categories in particular — advisory firms, flexible staffing organizations, business process outsourcers (BPO) and "RegTech" providers — offer investment opportunities, especially for midmarket-focused investors. These categories are all capitalizing on the compliance needed to meet existing regulation and remediation situations.

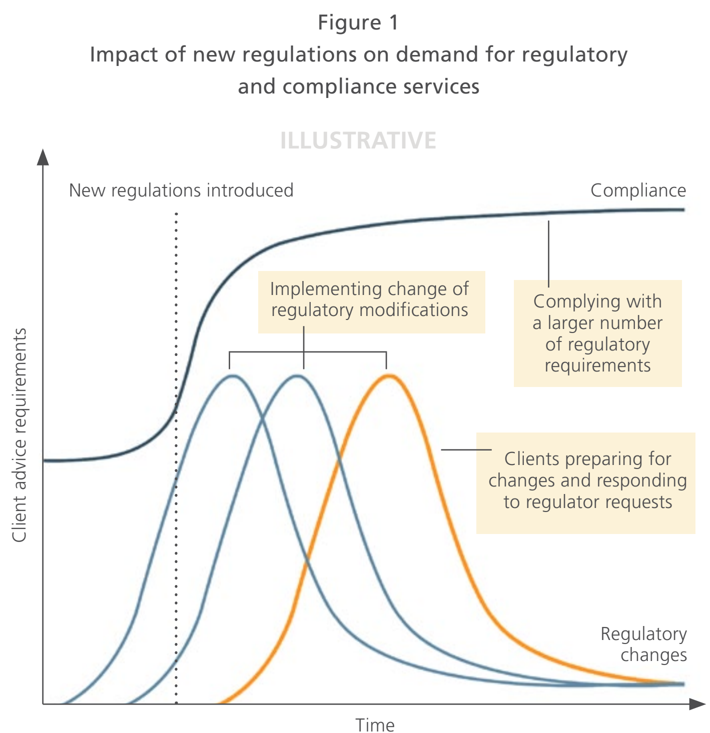
There are also long-term opportunities as regulation is developed in response to business innovation, investigations or globalization issues such as in the harmonization of tax frameworks; and remediation services for miss-selling and noncompliance will continue to be required (see Figure 1). This paper analyzes the dynamics of each of these business services categories to assist investors as they review the respective markets.

Advisory firms

Outside of the Big Four — Deloitte, EY, KPMG and PwC — and their closest global competitors, there are a substantial number of midsize firms advising regulated financial institutions on issues such as the implications of ring-fencing in banking, and planning and implementing structures and processes for compliance. These firms also often help their clients with remediation matters and forensic accounting, especially during litigation.

Most opportunities are with midsize advisers, and potential investors need to see evidence that the core value of the target

Figure 1
Impact of new regulations on demand for regulatory and compliance services



Source: L.E.K. analysis

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business is not weighted to just a few people and that it has strong, long-term relationships with its clients. Understanding the target's channels to market and its peer relationships is critical. Marketing strategies are often complex, especially in relation to the Big Four, which can be competitors and partners. Large law firms are also a key route to generate lucrative regulatory work, for example in LIBOR.

Flexible staffing providers

Recruitment companies have benefited from increased financial services regulation as organizations need greater volumes of resource and additional skills to deal with issues such as remediation programs, and also to implement change to ensure compliance. There continues to be a significant demand for flexible workforces to comply with regulatory needs.

As with the advisory category, there are many suppliers in the flexible staffing market, from the global leaders like Adecco and Randstad to a substantial number of midsize players. The core investment opportunities are in the midmarket where organizations face similar route-to-market challenges as do the advisory firms, often partnering with their larger counterparts to access the ongoing pipeline of work. Typically, there is a financial trade-off between the volume of staff provided to clients and the revenues per contractor gained, so this too will be a key consideration for potential investors.

Business process outsourcing companies

Many midsize and large financial services organizations have reduced their burden of regulatory compliance by outsourcing processes to regulated BPO companies that specialize in such matters and can do the work at far lower cost due to volume servicing. There has been a lot of BPO contracting in the U.K. mortgage industry, for instance in areas such as loan servicing and customer management, particularly by small banks and mutual societies, and also by independent financial advisors (IFAs).

The BPOs with sustainable models for regulatory business provide an opportunity for investors, although the investment thesis is based on broader outsourcing and efficiency trends, and not solely on regulatory compliance.

RegTech

The investment opportunity in RegTech is in software companies that are automating elements of the regulatory value chain around real-time monitoring, reporting and compliance — much of which would previously have had a significant manual component. The global market is seeing enormous growth and is expected to be worth $120 billion by 2020, according to Reuters[1]. One of the fastest developing areas relates to Know Your Customer (KYC) and Anti-Money Laundering (AML) regulations, which require considerable capability for ongoing data processing. There has been much Venture Capital activity in this area. The challenge for investors will be to ascertain which of the VC-backed firms have sustainable business models that warrant their interest.

Another potentially investable RegTech segment is companies that provide streamlining services — for example, if a bank needs to make a complicated investigatory submission to a regulatory body with hundreds of people submitting a range of different documents.

The eDiscovery sector, whereby providers enable computer processing of thousands of documents for litigation, again replacing manual labor with commensurate speed and cost benefits, is another sector providing potential opportunity for investment.

Finally, there are also emerging monitoring propositions to monitor customer behaviors (e.g., bank account data) and identify potential fraud and other criminal activity, or monitor keywords in emails or chat rooms within an organization to identify potential illegal practices.

Investor checklist: attractive, but not for everyone

Investors across all these business categories will need to be comfortable with the relative lack of revenue visibility in many target organizations (particularly for advisory and staffing solutions businesses), because of the high levels of unpredictability in the timing and quantum of regulation and remediation initiatives, and the commensurate impact on income flow.

The RegTech sector has inherent risks because propositions are often unproven or have been rolled out to a very limited number of clients. Sustainability of the business model (i.e., customer lifetime value versus customer acquisition cost) is often an issue.

A final challenge is that many potential targets are owner / partner-managed and may not be keen on external investors. Nevertheless, for those investors willing to seek out target organizations and conduct in-depth due diligence, there are significant returns to be achieved.

[1] http://citywire.co.uk/new-model-adviser/news/advice-firms-look-to-technology-for-regulatory-answers/a1004119

About the author

Diogo Silva is a Partner in L.E.K.'s London office. He began his L.E.K. career in 2006, having completed an MBA at INSEAD, where he graduated with Distinction. Diogo left in 2010 to join Barclays, where he held roles in the COO office of the Investment Bank and also in Group Treasury. Since re-joining L.E.K. he has focused almost exclusively in the financial services sector, specifically in retail and corporate banking, payment services, specialist lending and asset and wealth management.

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