Wall Street & Technology

Private Equity Firms Fueling the Growth of Electronic Trading

June 23, 2007

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FT Partner's McLaughlin, however, says, "There are still plenty of deals out there. A lot of the companies getting finance were created five or six years ago. There are plenty of firms being created now that in five or six years will be looking for capital. But a lot of the really good companies have been pursued by these private equity firms"

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It's good to be in the financial technology industry these days — especially if your company is getting calls from private equity firms looking to invest in one of the economy's hottest growth sectors.

Dan Dykens, CEO of Boston-based Norbury Financial, says he's been getting cold calls from venture capital firms interested in investing in his research management solution. The former hedge fund manager built Norbury Links, software designed to manage E-mails, research notes and filings. Dykens currently is selling the technology to hedge funds and traditional mutual funds, as well as funds of funds and even private equity firms. "We haven't taken any private equity to date," Dykens says, but he's considering it.

Over the past few years, private equity firms have invested billions of dollars in the financial technology sector, particularly in electronic trading, and the pace of deals has picked up recently. In January, Automated Trading Desk (ATD), a high-tech market maker in U.S. equities that is expanding into equity options, announced a $60 million investment from Technology Crossover Ventures (TCV). On April 2, FX Solutions, an electronic market maker in the retail foreign exchange market that white labels an automated execution platform, reported that it received more than $100 million from Francisco Partners. Also in April, Getco, a privately held automated market maker in Chicago, reportedly raised $300 million from General Atlantic (GA), a former investor in Archipelago and NYMEX. And Sequoia Capital, a technology-focused venture capital firm with a 30-year history of investing in Apple, Cisco, Yahoo and Google, recently made an investment in an automated market maker (specifics have not been disclosed).

Today, "There is so much innovation and change taking place across the capital markets," observes Scott Carter, a partner at Sequoia Capital. In the past, however, "Even if you had the idea that you could apply technology to the capital markets, it was dominated by human beings in pits," he notes.

Clearly, the convergence of technology and finance is attracting the new wave of private equity money. "You have a massive trend toward electronic trading, you have significant regulatory change with Reg NMS being implemented, and you have increasing market structure trends and a focus on globalization," says Bob Trudeau, general partner at Palo Alto, Calif.-based TCV. "All of these market structure trends create some market opportunity."

Trudeau explains that one of the most important factors in most of TCV's investments is the management team. "The first motive is to back a great management team," he says, adding that he got to know the management team at ATD over the past three years before TCV invested in the market maker. "To watch these guys execute successfully over the last few years made it exciting to partner with them," Trudeau remarks.

ATD CEO Steve Swanson says the private equity firm has opened doors through relationships with the broker-dealer community and the buy side. "The fact that TCV has made an investment in us legitimized who we are," he says.

But selling a stake in one's company doesn't come without strings attached. Private equity firms typically sit on the board or control management of the companies in which they invest, and they often bring in new management. "We help out with recruiting, advice, strategy, [and] product and customer introductions," relates Bob Greene, managing partner at Contour Ventures, an early stage venture capital firm in New York that recently invested in YellowJacket Software, a peer-to-peer communications network for energy traders in the OTC derivatives market (see "Yellow Jacket Software Captures Market Data from Instant Messaging Converations").

Greene notes that one of the advantages of being located in New York is that the VC firm sees a lot of deal flow. "We're right here in New York City," he says. "It's Wall Street guys selling to Wall Street guys."

In fact, private equity firms are targeting both the financial technology companies and the financial services companies themselves. In May, for example, TCV and Spectrum bought a majority interest in RJ O'Brien, the world's largest futures and commodities merchant. Though the size of the investment was not disclosed, according to one source familiar with the deal, each private equity firm put up $200 million.

While it's hard to believe given the frenzy of recent deals, Stephen Bruel, an analyst with TowerGroup's securities and capital markets practice, says financial technology historically has been an under-invested sector for most private equity firms. But, he notes, as a high-growth area, electronic trading is helping to change that. "Among the macro trends across the securities landscape, [private equity firms] are going to be looking for the electronic trading platforms," Bruel says. "The companies in that sector are going to be most coveted."

Supply and Demand

"There's almost a rush to invest dollars in electronic trading technology today," comments Peter Kent, CFO at ATD. "You saw General Atlantic invest in Arca, which was a technology play also. Similarly, GA made an investment in NYMEX, where their play was to make it more electronic. So the rush is to invest in those who use technology in the trading business. And it's a rush that is caused by an ever-increasing value of these properties but also a scarcity of these properties. ... So there's a supply and demand situation going on here — there are a limited number of assets with good technology bases."

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Some VCs, however, are looking for more-disruptive, emerging technologies, according to Alexander Harrison, a partner at Sequoia Capital. "Sequoia Capital is trying to be in business with the companies in the financial technology revolution that are building market-defining technologies," he says.

The Market? It's Electric

Some of the established private equity firms that made early investments in ECNs when electronic trading began in the U.S. equity markets are looking for similar themes to play out globally and in other asset classes, such as fixed income and foreign exchange. GA's reported $300 million April investment in electronic trading firm Getco — which is active in Europe and uses computer formulas to rapidly execute buy and sell orders across multiple asset classes, including equities, fixed income, commodities and foreign exchange — is an example of this. "What attracted us [to Getco]," says Rene Kern, managing director of Greenwich, Conn.-based GA, "was its strong management team, a well-articulated business strategy in electronic trading and the fact that they have applied technology to their business model in a highly strategic and compelling way."

GA, which historically has invested 20 percent of its portfolio in financial services, according to Kern, distinguishes itself by identifying themes that have long-term potential that can be applied on a global basis, he continues. "With respect to financial services, we have made a significant commitment to the electronification of capital markets," says Kern, noting GA's investment in Archipelago that led to its acquisition by the New York Stock Exchange, which then merged with Euronext. In March 2006 GA invested in NYMEX, which completed an IPO in November 2006. And earlier this year, GA invested in the National Stock Exchange of India, an electronic exchange.

Similarly, TA Associates — an early investor in Datek, which was sold to Ameritrade, and Island-Instinet, which was sold to Nasdaq — has turned its wallet toward fixed income, credit derivatives, and middle- and back-office platforms for hedge funds. "We're investing in the infrastructure of the markets," says Jonathan Meeks, managing director of Boston-based TA Associates. Currently, the firm holds stakes in ION Trading Group in the fixed-income space; Creditex in the credit-derivatives area; and GlobeOp Financial Services, which services hedge funds as a middle- and back-office outsourcing platform. In addition, TA owns eSecLending in the securities lending space and SmartStream Technologies, which is used by 1,000 firms as a back office in derivatives trading.

According to Meeks, in contrast to the big buyout deals of the last few years — in 2005, for example, SunGard went private with an $11.3 billion buyout led by SilverLake Partners, and SS&C Technologies was acquired by the Carlyle Group for $962 million — the current deal frenzy is oriented toward growth. "Those were kind of rollups," says Meeks, referring to leveraged buyouts such as the Sungard and SS&C deals. "The natural result of rollups is that you want to run them for their cash flow. The strategy is usually to get good returns, adding a lot of leverage to the deals because they're kind of mature portfolios of companies," he explains. "We get more excited by the high-growth companies that are in emerging [areas]."

For instance, Meeks says, back-office functions and business processing, and Web services and workflow are now becoming more strategic. "Those are the kind of things that SmartStream does," says Meeks. "When you're operating in a derivatives trading environment, you really need to have your back-office systems under control."

Similarly, in 2005 Sequoia Capital invested in New York-based Traiana, whose Harmony service is a cross-asset, post-trade processing engine used by prime brokers and dealers serving hedge funds and investment managers. "If you are a prime broker and you're hooked up to Traiana, all [of the post-trade settling] can be done without human intervention," notes Sequoia's Carter.

It's the Platform, Stupid

A key ingredient in all of these capital markets deals is a scalable technology platform. For example, "The team at FX Solutions has invested in a technology platform that can handle very high volumes and spikey volumes, as well as routine market conditions," says Francisco Partners managing director David Golob, who led the team that invested in FX Solution and who sits on FX Solution's board.

In the case of ATD, TCV's Trudeau says, "They have a technology platform that is truly differentiated in the market and will allow them to grow and scale. As a growth investor, one of the important aspects behind these partnerships is to take the platform and extend it into adjacent markets — international equities would be one and equity options would be another."

Once the private equity firms own the financial tech companies, they look to grow revenues. To do that, TA has been helping the companies in its portfolio make acquisitions of their own. For example, Creditex acquired Credit Trade, becoming the No. 2 firm in the credit derivatives space. It also launched T-Zero, a platform for processing of complex derivatives, and Q-WIXX, a platform that enables hedge fund clients, correlation desks and buy-side firms to trade large credit derivative portfolios electronically.

TA also was an early investor in Lava Trading, which was sold to Citi, and the InterContinental Exchange (ICE), an upstart electronic commodities exchange whose stock went public at $26 and was recently up to $150 a share. "It's a business nobody really paid attention to when we first entered," says TA's Meeks, referring to commodities trading and the ICE, which is engaged in a bidding war with the Chicago Mercantile Exchange to acquire the Chicago Board of Trade.

"If you talk about the derivatives exchanges, the commodities exchanges — that is the hottest space now," asserts Seth Merrin, founder and CEO of Liquidnet, the global electronic block-trading marketplace for institutional investors. "This is a great space that is going to be consolidated up, and so it has a limited downside."

Private Equity Bubble?

But Merrin warns there could be a bubble going on now. "There's so much private equity money out there looking for deals — it's sort of a sellers' market these days," he says.

FT Partner's McLaughlin, however, says, "There are still plenty of deals out there. A lot of the companies getting finance were created five or six years ago. There are plenty of firms being created now that in five or six years will be looking for capital. But a lot of the really good companies have been pursued by these private equity firms, so it can't go on forever."

Using an analogy to the Gold Rush of 1849, Norbury's Dykens says the private equity firms are looking for "picks and shovels" companies — the people who made money sold picks and shovels, not those that went digging for gold, he explains. "As the hedge funds take in more money and products, they buy more seats," Dykens says.

TA's Meeks agrees. "There's a technology arms race going on [on Wall Street]," he says. "Everybody is making a lot of money, and we want to supply the combatants.