Updates
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# Coevolution: Reimagining Mergers and Acquisitions, Partnerships, and Engagements in the Financial Industry

As the COVID-19 pandemic has raged on, financial institutions and banks have withstood its effects and are digitally transforming out of necessity. Many fintech companies, with technology at their core, are seeing double-digit growth. Large technology companies have proven to be critical partners to financial institutions by providing them with essential technologies. However, survival is not enough and sustaining growth will become more challenging in a fiercely competitive and highly regulated financial industry. The need for optimization and acceleration of digital adoption requires urgency and more than just an organic approach to growth and innovation.

Few financial institutions and banks can continue to pour billions into digital innovation at this accelerated pace and fewer have the necessary talent and resources to sustain demands for digital transformation given the challenging market for technical talent. Meanwhile, fintech companies will inevitably face scalability issues and need to retool technically and operationally to be able to withstand enhanced regulatory obligations and oversight. Organic growth alone on the journey of digital optimization and acceleration is unlikely to yield the desired results at the speed needed to match the accelerated change necessitated by the pandemic.

The time is ripe for all industry players to coevolve and to grow collaboratively. Collaborating, partnering, and even consolidating will bring strength and momentum and will allow the parties involved to harness the power to propel them forward at a pace necessary to compete effectively. The pandemic crisis has shown that the opportunity to coevolve in the financial industry is greater than ever. Traditional financial institutions, fintech companies, and technology providers have a singular opportunity to unite and complement each other in optimizing and accelerating the digitization of the financial services industry. The speed of change requires financial institutions and fintech companies to closely examine partnership opportunities to achieve the scale, speed-to-market, and technology prowess their customers demand. Together, these entities will accelerate innovation through greater technology scale, a new approach to design and deployment, and the building of a strong foundation of compliance.

Coevolution will likely replace a culture of distrust between these stakeholders and can provide an opportunity to allow institutions, regardless of their size, their technology, or their research and development budgets, to accelerate their path to digital optimization. For fintech companies it is an opportunity to partner with institutions that can bring scale, core competencies in financial services, and a robust culture of compliance.

Innovative use of mergers, acquisitions, partnerships, and other forms of alliances is essential for a successful digital acceleration strategy. Deals and transactions resulting in collaborative relationships are at the heart of coevolution and successful engagements. They can take several forms and vary in their scope and other aspects. In this update, we will explore the need to shift the approach to collaboration and recommend some practical steps to prepare for such an important engagement.

**Why Coevolution?**

The pace of dealmaking, investing, acquiring, merging, consolidating, and strategically partnering in the technology and financial services space has seen incredible growth over the past decade. FT Partners reported in its Q2 2020 Quarterly Fintech Insights that in the period from 2010 through 2019, 8,076 fintech M&A transactions were reported, with 988 taking place in 2019. During the same time period, 12,175 reported fintech financings occurred, of which 1,823 occurred in 2019. The pace of M&A and financings accelerated during this period and is expected to continue to do so. *FT Partners Research, Q2 2020 Quarterly Fintech Insights, July 2020,* https://www.ftpartners.com/fintech-research.

Traditionally, in addition to the active participation of venture capital firms in supporting fintech companies' ventures, "collaboration" has largely involved financial institutions either (1) gobbling up smaller technology companies or fintech companies, or (2) licensing software or similar technology from technology or infrastructure providers. While that approach will continue to a certain degree, there is a need to reimagine relationships between the various stakeholders. Time to coevolve!

The industry is ready to move from the traditional uneasy and cautious relationship between financial institutions and technology companies to a model in which it can accelerate and thrive. The result will be carefully crafted relationships that meet the current needs of traditional financial institutions, fintech companies, and technology companies, while creating an ecology of collaboration and innovation to enhance the efficiency and competitiveness of all as their markets change.

For many years, traditional financial institutions and technology companies existed in different worlds. Financial institutions and banks existed in a highly regulated and organizationally siloed world with a rigid, by-the-book culture that did not promote innovation outside the world of financial products. They had the financial resources and customer base to support tech-centered innovation but did not have the organizational culture or systems to support an advanced technological vision for products, customer experiences, and other critical functions. On the other hand, fintech companies, with a highly evolved and tech-centered view of financial services, maintained a culture of rapid innovation that centered around evolving customer experiences. Fintech companies created the culture to support and promote their technological development and vision of highly evolved financial services, but many did not have the financial resources or customer base to effectively compete with traditional financial institutions. In addition, technology companies did not have the organizational infrastructure or mindset to thrive in a highly regulated environment. These two corporate "species" competed, and the extent of their collaboration was peripheral at best.

To survive and grow during these unusual times, there is a deep need for the financial industry to reexamine the coexistence and collaboration between the various players. The theory of "coevolution," borrowed from biology and highlighted by Kathleen M. Eisenhardt and Charles Galunic in their 2000 *Harvard Business Review* article, emphasizes the importance of creating cross-business synergies. They defined coevolution as follows:

"It refers to successive changes among two or more ecologically interdependent but unique species such that their evolutionary trajectories become intertwined over time. As these species adapt to their environment, they also adapt to one another. The result is an ecosystem of partially interdependent species that adapt together. This interdependence is often symbiotic (each species helps the other), but it can also be commensalist (one species uses the other)."

At the heart of the coevolution approach is an effort to effectively capture the synergies between the parties and allow them to each bring their strengths to the relationship. The recent challenge for traditional financial institutions and technology companies has been to create relationships (legal and otherwise) that will permit and encourage each to (1) bring to the relationship the experience and cultural and financial advantages enjoyed by that party, (2) use those advantages in the context of the relationship to address the current and foreseeable challenges of the financial institution, but also (3) create an ecology of collaboration that will incentivize each to develop and progress to the advantage of the other as the relevant market changes.

The financial industry has timidly moved down the path of coevolution. However, trends started shifting in recent years. Some financial institutions and fintech companies began forging relationships that draw on the strengths of each. What began as a contractual relationship that resembles a procurement of products, software, or services to support a niche function in the financial institution or bank started evolving into collaboration engagements and partnerships to grow technologically and organizationally. Strides can be made when both parties shift their mindset to collaboration and partnership and structure their relationship to promote that mindset, rather than maintain a procurement/supplier relationship.

Given the strengths and challenges of each segment in the technology and financial services ecosystem, the parties have the opportunity through their engagement either to evolve symbiotically, by helping each other, or to leverage each other's strength and capabilities to complement each other. With coevolution, in contrast with a traditional acquisition or procurement/supplier engagement, there is a need to balance the ability to continue to collaborate and create synergies while maintaining some independence in order to continue to grow and compete. Establishing such a balance in an intensely competitive market that is accelerating at lightning speed requires careful consideration, planning, and execution.

## Steps Towards a Successful Coevolution

The structure of a tech-centered, coevolving relationship will not be the same for each company. The needs and cultural imperatives of a large national bank may be very different from those of a regional or community bank or non-bank lender. It may be that smaller technology companies that focus on a smaller segment of the financial services industry will be able to devote more focus to a specific function of financial services and react more nimbly to customer needs and market changes than a larger technology company. Keeping in mind the goals of bringing respective advantages and creating an ecology of collaboration, the structure and organization of the relationship will be different for these different players.

While there are no guarantees for a successful coevolution, the following are some of the steps and practices that can put the relationship on a successful path:

**1. Be Clear About Organizational Goals, Strengths, and Opportunities.** The enterprise's awareness and understanding of its strengths and opportunities for improvement are foundational elements for any successful engagement. Each institution and company must maintain clarity around the ultimate goals that are driving its innovation roadmap. It must have a realistic view as to where it is on the digital journey and the location of the key destinations. Is it customer acquisition? Modernization of core infrastructure? Reduction of costs and enhancing efficiency? Improvement of regulatory compliance? Or expansion into a new adjacent market using the power of technology? Potential partnership and alliances between a financial institution and a fintech company should be based on clear goals and objectives with the financial institution maintaining very focused vision on the desired outcomes based on the factors discussed above.

**2. Gain Market Insights and Conduct Thorough Market Due Diligence.** Significant due diligence is required in selecting the optimal partner to complement one's own strengths, capabilities, and gaps. The parties need to gain insights into each other's technology, reach a deep understanding of the strengths and challenges of various players, and get a sense of the culture of the various partnering candidates. Often in traditional mergers, acquisitions, and partnerships, the parties look for harmony of cultures, goals, and approaches. With coevolution, however, where cross-business learning, competitive collaboration, and synergies are key to a successful engagement, harmony is not the goal. Instead, the parties assess their synergies through a mutual and deep understanding of the other's market strengths, capabilities, goals, and culture to establish an ability to collaborate without domination and control.

**3. Structure the Right Deal.** These relationships can be structured as joint ventures, joint development agreements, corporations, contracts, carefully crafted acquisitions or licenses, or other arrangements that do not neatly fit into a traditional legal structure. Sometimes the structure of the relationship can greatly influence whether an ecology of collaboration develops. When selecting and structuring the deal, keep in mind the following:

- **Different Contributions.** It should be assumed that each party will bring something different to the arrangement. One may bring financial resources, a client base, and a culture of compliance, while another may bring technology and a nimble innovative culture, and a third may bring necessary regulatory compliance. The structure of the arrangement should incentivize each to freely contribute to the venture and adapt as the venture progresses or circumstances change.
- **Different Structures Have Different Attributes.** Each structure has its own attributes, which may promote or frustrate the parties' purposes and the collaborative culture. A joint venture, for example, is an arrangement in which the parties pool their resources to pursue a common goal. A traditional financial institution and a fintech company may agree to enter into an arrangement in which each will contribute their unique resources to digitize certain financial operations and to develop or refine technology that will keep both parties on the forefront of operational efficiency. That arrangement can take the form of a traditional corporation, a limited liability company, a partnership, or merely a contract. A traditional C corporation contemplates a shareholder structure that is more difficult to customize than a partnership or an LLC. However, the form of stock ownership and corporate governance structure (and the body of law that has developed around traditional corporations) may be an incentive to the parties to the venture to collaborate for its success. In addition, if the venture wants to attract third-party investors, a traditional C corporation is the preferred structure. A limited liability corporation or a partnership permits the parties to design a compensation waterfall and governance structure that does not fit neatly within a traditional corporate structure. A contract among the venturers can be effective when corporate ownership is not necessary or is an impediment to reaching agreement. The venturers can consider and design a structure that takes the motivating factors of each type into account.

When adopting a structure, consider the purpose of the arrangement. Many venturers are not motivated solely by monetary return. For example, some are more concerned about creating systems that can be spread throughout their organization, accelerating adoption of digitized operations or enhancing customer experience. Often of great concern to venturers is their ability to direct the development of intellectual property to be strategically compatible with their goals. An arrangement that has been structured to enhance collaboration and coevolution will include financial incentives to motivate financially oriented venturers. Strategic incentives will be included for venturers who will permit them to advance their strategic goals. In all cases, incentives should be structured for the medium to long term. Coevolution works best and benefits all venturers when the structure creates points of collaboration that evolve over time in response to successes, failures, and changed circumstances.

**4. Strike the Right Balance of Operational Execution.** Several recent deals between financial institutions and technology companies seem to have been implemented in a different way than traditional acquisition or license agreements. They are structured to create and incentivize collaboration between the entities by establishing multiple points of collaboration without stifling the competition between the parties. At these points of collaboration, teams from both sides are often given the mandate, resources, and organizational running room to address a current or future challenge to the financial institution by application of technology in development. To be effective, a point of collaboration should also have sufficient peripheral vision to recognize and address challenges adjacent to the mandated task. We note that often these relationships are structured to include a coordinating person or body. The coordination function should be conducted primarily to inventory knowledge and experience and to avoid duplication of effort. The coordination function should be conducted with a light hand to avoid chilling innovation at the points of collaboration. Some additional recommendations include:

- **Choose the Right Type of Points of Collaboration.** Points of collaboration with managers too senior in an organization may result in failure to recognize opportunities at the operational level. Points of collaboration with personnel too junior may result in failure to recognize systemwide opportunities to collaborate.
- **Choose the Right Number of Points of Collaboration.** Too few points of collaboration can result in missed opportunities to collaborate and strengthen the relationship. Too many points of collaboration may result in the relationship not being nimble enough to change in response to opportunities and needs. It can also result in smothering the innovative culture that the tech company brings to the relationship.

**5. Be Creative With Data.** Data-driven review and analysis of the relationship should be used to shape and adjust the relationship over time. However, the data should not be used for a traditional return on investment analysis. To maintain the innovative culture that the technology company personnel will bring to a point of collaboration, there needs to be a "fast fail" tolerance for lessons quickly learned and the value of those lessons needs to be factored into the data-driven analysis of the relationship. A devotion to relevant data will result in the points of collaboration evolving over time to the benefit of both the financial institution and the technology company.

Drawing on our experience with clients in the fintech industry, it is clear to us that the old methods of developing and adopting tech-oriented solutions to financial industry challenges will no longer work. It is also clear to us that the traditional financial institutions, fintech companies, and tech companies cannot successfully go it alone in this industry. The leaders in fintech will be those companies that understand that the current speed of change requires a commitment to coevolution to achieve the scale, speed-to-market, and technology prowess needed to meet customers' digital demands. Coevolution can provide the optimal opportunity goals and help parties achieve collaboration without losing their own identities. It also can open the door for a greater and a healthier competitive landscape. The opportunities are abundant and the paths to be followed are diverse.



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