

[VENTURE CAPITAL]

The Middle Men

Financial Technology Ventures Muscles Its Way Into the Nexus of Technology And Financial Institutions

FT VENTURES: THE MIDDLE MEN.

The venture capitalists from San Francisco have some unusual strategies that seems to be paying off. They've also defined how VC firms can bridge the gap between financial institutions and the tech companies trying to prove themselves worthy.

The phrase “virtuous circle” can still make even the most steely investor shudder; after all, this was the term given to the late 1990s notion that increased technology spending increased productivity which funded increased technology spending, and so on. Yet virtuous circle seems to describe aptly—at least in theory—the business plan devised by the partners at venture capital firm Financial Technology Ventures.

FTVentures marries two unusual strategies for a venture capital fund: focus only on mid- to late-stage technologies that benefit financial services, and have as limited partners only

large financial institutions. The relationships feed on each other in numerous ways. By communicating frequently with the LPs, FTVentures hears first hand what the technology needs are, which gives shape to their investments. LPs, besides the potential investment returns, are continually briefed on the newest technologies—specifically, e-commerce enablers, software and infrastructure solution providers and payment sector technologies. And portfolio companies get investment and board member participation from VCs with keen insight into FIs.

“The model is unique, and exemplary of where a lot of VC firms are going to have to go. It really distinguishes them,” says

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Bill Burnham, a managing director at Mobius Venture Capital, a \$2.5 billion-asset fund focused on early stage technology investing. “When we’re looking at a deal that involves a financial services component, they are one of the first names we think of. It’s a great way to stand apart.”

San Francisco-based FTVentures got its start in 1998 when James Hale, Bob Huret and Scott Wu, all working at Montgomery Securities, decided to go their own way following Montgomery’s acquisition by NationsBank. The partners explained that the VC fund was a natural extension of the work they had done at Montgomery. “We took the opportunity to start our venture fund because we’d identified these companies, and we were doing introductions to VCs, and we were helping the VCs with the due diligence. And we realized we could do it differently, we could leverage our relationship with banks because we understood their focus in terms of their technology needs,” explains Huret, who holds the title of managing member with five others at the firm.

The first fund, Financial Technology Ventures I, raised \$200 million in mid-1998, and had the participation of 21 limited partners. The second fund, Financial Technology Ventures II, raised \$423 million by the summer of 2001—an accomplishment in itself given how dismally the market had turned in the intervening three years. That second fund included all 21 original LPs and added 18 more—bringing the total to 39. The list is a real who’s who in international financial services, including: Bank of America, Wells Fargo, Deutsche Bank, GE Capital, BNP Paribas, CSFB Group, AXA, Lloyd’s TSB, Sallie Mae, and Freddie Mac, to name a few.

“What I like so much about the FTVentures’ model is it’s a nice two-way communication; it involves potential users of the technology, and it helps FTVentures get a read on the right investments,” says Janey Place, president of Mellon Lab and online services at Mellon, a limited partner. “And it’s a fertile area for venture investing. Financial technology is one of the few areas that’s expected to see a year-over-year increase in spending, because just staying competitive requires constant investing in technologies.”

Though FTVentures has a reputation for being focused on late-stage companies—the partners describe their “sweet spot” as companies with \$2 million to \$15 million in revenue—they are quick to say that FTVentures will look at technology companies at any stage. One of the differences between the first and second funds is that the latter has an expanded mandate: it will consider investing in companies at an earlier stage of development, it will look overseas to invest, and it will make larger investments. “We will look at things very early on. We want to look at technology as early as possible,” says Robert Barrett, a managing member. Though he concedes that for an early-stage company to receive funding it needs to

“pass through the eye of the needle,” and early-stage companies make up a small part of the portfolio.

So far, FTVentures I has invested in 27 companies and is nearly fully invested, while FTVentures II has invested in six companies. The 10-year funds, which seek to be fully invested after the first five years, make an average investment of about \$10 million, which is roughly the contribution of each LP, Huret says. Given that the average life of the portfolio companies in FTV I is just three years, the partners say it’s too early to provide average return numbers. (So far seven of their portfolio companies have either been acquired or gone public.) FTVenture’s goal, principals say, is to perform in the top quartile of their VC peer group. Mellon’s Place adds that while limited partners in a venture fund typically expect returns in the 20 percent to 25 percent range, it’s no secret that the market has been in a protracted and severe slump.

Here, however, is another example of the virtuous nature of FTVentures’ model. Since, for many of the limited partners, financial returns are a secondary concern to the value of the intelligence gathering, these LPs are more likely to forgive lesser returns than traditional limited partners whose only interest is returns. Not only that, FTVentures effectively thins the risk among these investors, making losses more palatable, by taking \$10 million a piece from a larger pool versus \$100 million each from a small number of investors.

The relationship between the LPs and FTVentures can almost be viewed as an outsourcing arrangement in which the banks have enlisted FTVentures to perform ongoing, in-depth due diligence on the unwieldy field of financial technology. “Today there are 10,000 vendors. And typically banks are inundated by cold calls. It’s just not possible for them to sift through it all,” says Huret. “We help by being a resource, a window on these new technologies. We spend all day every day on them. We’ve seen thousands of companies. (An average of two companies a day pitch FT Ventures.)” “Occasionally we invest, but frequently we just let LPs know about them. We’ll e-mail short synopses of companies we’ve seen that they might be interested in.”

These e-mail synopses are sent out usually once or twice a week, and the responses FTVentures receives back is critical to the information loop, helping the managing partners to decide whether to pursue a possible funding (a process that typically takes four months), ignore the company, or most often, help FTVentures better understand the technical challenges faced by banks, identify trends, and ascertain what they should look for in future pitch meetings. For the managing partners, it’s been a constant lesson in keeping an open mind. “We’ve learned not to substitute our opinion of technologies for the judgment of the marketplace,” says Huret. “It’s not a question of whether it is a real ‘Wow,’ but will users buy it.”

Charles Goldman, svp of corporate development and venture investing at San Francisco-based Charles Schwab, another limited partner, values the expertise FTVentures brings to the table, even though Schwab sees many of the same technologies.

“Everyone and their mother wants to sell to Schwab. Let’s face it, if you have a financial technology, you’ve pitched it to Schwab,” he says. “But they are smart guys, very plugged in, and another set of eyes and ears to view these technologies.” Besides the e-mails he receives regularly from them and the detailed quarterly reports on the space, he values the informal talks they have throughout the year, both on the phone and in person.

For Mellon, the ties to FTVentures works on several levels. “We invested in FTVentures first and foremost as a venture investment,” says Place, who besides being president of Mellon Lab, sits on the board of Mellon Ventures Inc., which makes investments in a broad range of companies, both financial and non-financial. Aside from the hope for returns, the intelligence gathered on the steady march of technology companies through the offices of FTVentures can be put to good in other ways—identifying candidates for direct investment by Mellon Ventures, or identifying possible clients for the Mellon Venture’s own portfolio companies. On the Mellon Lab side, Place says, the goals are more strategic. “The constant stream of companies they’re seeing is helpful to us to see what’s going on.”

In the same vein, Keith Werner, vp of global alliances at Wells Fargo, another LP, describes FTVentures as a real “broker of information.” He says he benefits from the fact that FTVentures vets a huge number of technology companies, keeping him abreast of developments. But just as important, perhaps even more so, the partnership network clues him into what technologies other institutions are interested in; and the networking extends beyond the partnership itself to the VC and technology communities in general. The importance of this kind of communication, especially with fellow banks, is a reality of today’s market, he says. “We have to work with other financial institutions, with other systems and networks on security needs and technology standards.”

The way Werner sees it, one of the great benefits to the partnership is the way FTVentures helps portfolio companies keep the notion of interoperability in mind, and guides those companies to develop a broader, more holistic view of the market. There’s a tendency, Werner explains, for a start-up to build to the specific needs of the first big customer. “In the banking industry, there are a lot of interoperability standards. In this case, portfolio companies can receive guidance from FTVentures to design for all banks, instead of one bank, which makes for a stronger, more viable solution.”

Given the deep-pocketed LPs, and the stake they have in finding, buying and implementing the right technologies, an investment

by FTVentures would seem to auger well for any portfolio company. “Sometimes we’ll talk about a portfolio company and an LP’s eyes will light up,” Huret says. “That doesn’t guarantee a sale. We don’t have anybody’s checkbook or appointment calendar. But we get them in front of the right people at the right time.” This all goes back to the free flow of information between FTVentures and the LPs, which gives the managing partners a high degree of confidence that a certain firm will want to meet with a certain technology provider.

This frank exchange of information also puts the managing partners in an excellent position to identify nascent trends, says Scott Wu, a managing member. Some of those trends include: enterprise integration so companies can get a better overall view of a customer or product; business process outsourcing, i.e. moving whole lines of business overseas, like mortgages, to squeeze cost efficiencies; shifting from proprietary networks to IP networks capable of handling actual transactions; security, particularly as wireless local area networks proliferate; as well as the security spending forced by new regulatory requirements tied to the US Patriot Act’s fraud detection and anti-money laundering rules.

A good example of how this working relationship between FTVentures and LPs translates into identifying specific companies, says Wu, is the case of FTVenture’s investment in Banter, a San Francisco-based company that manages e-mail traffic. The company came to FTVentures’ attention because several limited partners were already using the technology—RBC Financial Group and Well Fargo. “All the LPs had voiced concern about this area. We worked in conjunction with LPs to see if it could help them, and decided Banter’s technology could be a help to them all.” So in September, FTVentures led an \$18 million investment round in the company.

Another example of the LPs identifying a problem in need of a technology solution is market data. “Most of our LPs spend a large amount of money on market data; it’s a real issue for them,” Wu says. So FTVentures went out and searched for a solution and found Caplin System in London, which provides real-time streaming of information using a technology that greatly reduces the costs to customers. FTVentures invested £5.5 million in March (about \$8.5 million).

Of course, just because LPs are using a product, or plan to use it, doesn’t guarantee success. Wu says one of the greatest lessons his firm re-learned is how slowly FI customers change behavior, no matter how sexy the technology. Case in point: 7*24 Solutions, a company that enables FIs to offer their clients access to on-line financial services via their cell phones and

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other wireless devices. That company went public in February of 2000, rocketed to \$134.50 a share, but by the middle of September of 2002 was trading at about 50 cents. Although Wu says the fund made out fine on its pre-IPO investment, he's "not happy" to see a portfolio company nose-dive. "We really thought these guys would tap into a burgeoning market, but it didn't happen."

"We learned a big lesson," Wu says. "It's incredibly difficult to change consumer behavior, and it's usually way down the curve, not when a technology is launched. We knew that, and we didn't even forget it, but we got caught up in the hype of wireless. I'm sure [wireless banking] will happen. It will happen down the road, just not in the time frame for us to make a return on an investment." ■



FTVentures
601 California Street
Suite 2200
San Francisco, CA 94108
phone 415-229-3000
fax 415-229-3005
www.ftventures.com