# Investing in Financial Providers to the Underserved

A surprisingly large percentage of American consumers do not have a savings or checking account with an insured depository institution (defined as "unbanked"), or primarily rely on check-cashing services, payday lenders, or other Alternative Financial Services (AFS) providers for their financial solutions (defined as "underbanked"). According to the latest data from the FDIC, 28.3 percent of U.S. households are unbanked or underbanked—a figure that translates into 68 million adults and is expected to grow.[1]

Unbanked and underbanked consumers have bypassed traditional banking products, and big banks have historically avoided these consumers due to concerns around high loss rates, regulatory issues, and perceived reputational concerns. However, the high fee structures often accompanying the products offered by AFS providers may justify an entrance into or expansion within the underserved banking sector. About 25 percent of U.S. households used at least one AFS product in the year of the FDIC survey, and they did so because they perceive AFS providers to be more convenient or accessible than traditional banking institutions.[2]

Given the growing number of underserved consumers in the U.S. and the evolving regulatory environment, a clear opportunity to serve these consumers exists. Including credit, payment, deposit, and other products, the fees and interest generated by the underbanked sector totaled approximately $78 billion in 2011, according to The Center for Financial Services Innovation. An increasing number of large banks, including Wells Fargo, have been aggressively seeking out the underbanked by offering AFS products such as low dollar amount, short term loans with relatively higher fees.[3] However, many of the AFS products offered by traditional banks carry requirements such as existing banking relationships, minimum balances, or significant fees.[4]

Recently, start ups have entered the market to capitalize on this niche group. San Francisco-based LendUp offers California residents the ability to borrow $250 for 30 days at a rate of 15 percent, and the ability to borrow more funds at better rates. LendUp received seed financing from backers that included Andreessen Horowitz and Kleiner Perkins Caufield & Byers.[5] Even non financial entities have begun to enter the space. Last year, Walmart, in partnership with American Express, began a new service called "Bluebird," which includes a prepaid debit card and was recently expanded to add services promoted as alternatives to checking accounts with features such as mobile bill pay.[6] Investments in these types of services and acquisitions of AFS providers are likely to increase.

[1] 2011 FDIC National Survey of Unbanked and Underbanked Households, September 20, 2011, page 3 (FDIC study).

[2] FDIC study, page 5.

[3] *The New York Times*, "Chasing Fees, Banks Court Low-Income Customers," April 25, 2012.

[4] 2011 FDIC Survey of Banks' Efforts to Serve the Unbanked and Underbanked, December 2012, page 5.

[5] *CNNMoney.com*, "A startup tries to fix payday lending," October 11, 2012.

[6] Walmart press release, "American Express and Walmart Announce the Addition of FDIC Insurance and Worry-Free Check Writing to Bluebird®," March 26, 2013.

## The challenges and benefits of entering the market

New market entrants and seasoned finance companies both face substantial regulatory requirements, political uncertainty, reputational concerns, and funding complexities. The underserved segment's characteristically high credit losses and low liquidity command high-priced financial services products. The annual percentage rate on a payday loan averages 225 to 300 percent, according to the Center for Responsible Lending. Not surprisingly, these rates attract the attention of regulators and consumer advocacy groups and have been limited or prohibited in certain states. These challenges are complicated by the relatively new Consumer Financial Protection Bureau, which has been actively collecting consumer complaints and expanding its oversight. Furthermore, certain evolving aspects of the Dodd-Frank Act, particularly around improving consumer borrower protection, remain in question. Despite these challenges, the high financial returns associated with AFS products remain attractive to both financial services companies and private equity (PE) firms. The most desirable acquisition targets are supported by experienced and competent management teams, strategic footprints, competitive and reliable funding structures, and conservative risk management functions.

PE firms entering the market face similar challenges to financial services companies. Although PE firms are attracted to the high yields offered by AFS offerings, they remain cautious in light of potential reputational risk and regulatory and political uncertainty. Additionally, PE firms may have difficulty securing competitive financing, a process requiring robust forecast assumptions and an experienced management team with a successful track record. Despite these issues, private investors have expressed continued interest in the space and are actively seeking attractive targets. Nadim El Gabbani, a principal with Blackstone, believes there is an opportunity to back innovative management teams in providing real benefits to customers alongside predictable returns for investors. He says, "Key elements that we look for include advanced credit analytics, a multi-channel distribution network, and a robust compliance function suited to the unique needs of serving underbanked consumers. Over time, we anticipate that increasing regulation should lead to consolidation of the industry, benefiting companies that are able to deliver high-quality products in a responsible manner." Recent PE investments in the underserved segment reflect the diversity of the product spectrum, including sub-prime auto (for example Aquiline Capital Partners' acquisition of First Investors Financial Services), consumer installment lenders (such as the sale of Mariner Finance to an undisclosed investor group), and payments (The Carlyle Group, TPG Capital, Bain Capital, GTCR, and unnamed strategics are reportedly bidding for MoneyGram International[7, 8]), among others.

## Target identification and due diligence to manage risk and rationalize the investment

Buyers with industry acumen and the patience to find the right mode of entry are best-suited to overcome the challenges of entering the underserved market. Target selection criteria need to be defined in the early stages of the process, and preliminary vetting efforts should concentrate on aligning the acquirer's risk appetite with return requirements. Company culture can be of preemptive importance in determining whether the target's operations are conducive to stringent risk management and customer care while generating favorable returns.

Deep-dive due diligence is also of fundamental importance to avoid risks and maximize the benefits of an acquisition, particularly in the underserved segment. KPMG's Tim Johnson advises potential investors to focus on the following issues during due diligence:

- Pin down a reasonable estimate of normalized earnings. Consider significant changes to reserves, impairments, loan sales, yield and cost of funds elasticity, shared services, and other one-time costs to assess the true run rate of the business.
- Re-grade a sample of the target's lending products, and independently assess reserve levels to avoid paying for an over-stated balance sheet;

[7] *SNL Financial*, "Report: Private equity companies bidding for MoneyGram," June 28, 2013.

[8] *Mergermarket*, "Moneygram reaches out to strategics – industry sources," June 28, 2013.

- Analyze the target's funding sources to determine stability and availability of existing debt, and identify potential synergies related to cheaper costs of funds and higher advance rates;
- Scrutinize the assumptions supporting growth strategies and aspirations to assist in understanding the target's true potential;
- Perform an in-depth evaluation of the target's risk management function to provide insight into needed investments, potential exposures, and risky products, services, and practices; and
- Evaluate potential contingencies such as unfair lending practices, regulatory or tax exposures, outstanding legal issues or others, and build these considerations into the purchase price or obtain protection through contracting.

Advisers with experience in this sector can assist in identifying the regulatory hurdles, funding requirements, and market appetite associated with various expansionary strategies. Also consider whether the incumbent management team is adequate to execute your investment strategy or whether supplemental support is required.

## Conclusion

Opportunities abound to serve the underserved, however mitigation of the associated risks is paramount to success. Traditional and non-traditional financial services firms stand to generate incremental returns by leveraging existing risk management competencies while launching new products or markets. Private equity investors can maximize their chances of success by targeting companies with well-established product offerings, flexible operating platforms, and robust risk management functions. The expanding population of underserved consumers needs financial solutions; diligent providers can benefit by serving them.


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