FINTECH 2021

FROM CRISIS TO CONSOLIDATION

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Introduction

For most people, life and work have changed fundamentally since the Covid-19 crisis began – and there are concerns that the crisis could still worsen again . Most areas of the world's economy have been profoundly affected too, and the Fintech sector is no exception. Fintech has been both an epicentre of the crisis – and has also been central to recovery efforts, as payments have moved online and governments have sought to disburse financial support efficiently.

Now is the time to assess, and plan for, what 2021 holds for the Fintech sector.

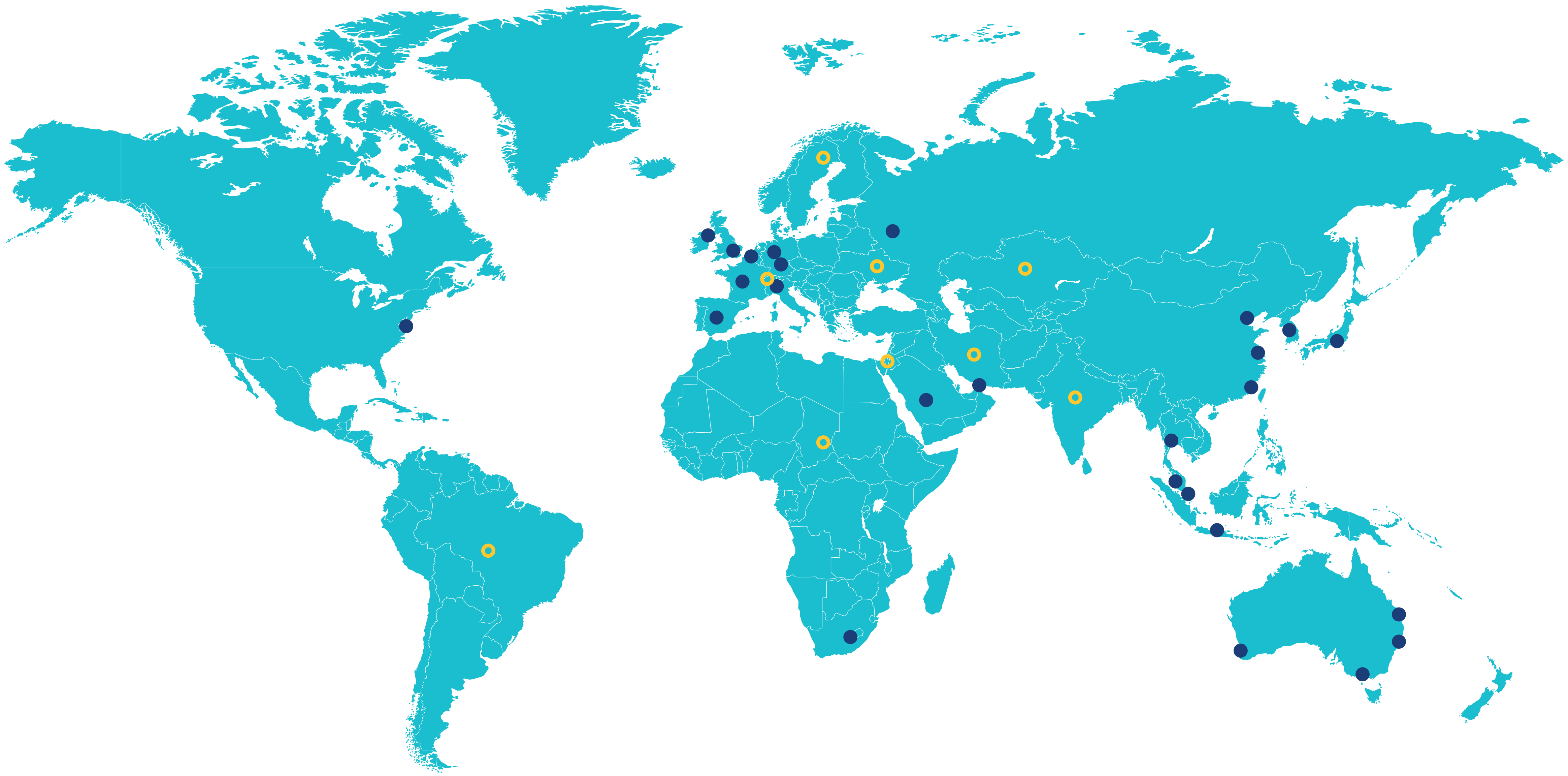
In our view, the crisis will significantly accelerate the development of the Fintech sector, which will move further into a new phase of consolidation and partnering.

Consumers and businesses have been forced to use and provide financial services remotely, and this has created an urgent need to digitise (for those who have not already done so) and to improve further their use of available tools (for those who have).

This is a genuine paradigm shift: there will be no return to the use of cash, cheques, and physical bank branches as the default.

The question is: how will this alter the Fintech ecosystem, and the relationships between incumbent financial institutions, challengers, and the big technology firms?

> "The pandemic will accelerate the shift to digital, accelerate the shift from commodity products to intelligent services, and permanently reshape the financial services industry".
> **11:FS**



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How has the crisis affected the Fintech sector so far?

Let's start with how the Covid-19 crisis has affected the Fintech sector so far.

Fintech refers to the use of technology to improve the provision of financial services, or to deliver entirely new products. This means that the Fintech sector is both broad-based and populous, including everything from global incumbent financial institutions, to new start-ups seeking to develop new products. And, of course, it includes the "BigTechs" such as Google, Amazon, Facebook, Alipay, WeChat, and Apple.

Given this range of participants, the crisis has inevitably affected Fintech firms in different ways. In assessing the future of the sector, understanding these differences is crucial.

The large, listed global financial institutions and BigTechs were affected earlier and more rapidly than privately held businesses, when global capital markets plunged in March and April. There was immediate, and severe, share price pressure.

But these firms are very highly capitalised, have enormous liquidity, and are able to raise fresh capital on the public markets if they need to. As such, Covid-19 has not represented an existential threat to these firms. In fact, as we discuss later, it has created an opportunity for them to further improve their position. Apple has reinforced this recently, by achieving an unprecedented market capitalisation of US$2 trillion.

By contrast, high-growth, early-stage, private Fintech businesses are often loss-making – and this includes some of the best-known amongst them – or make narrow profit margins, as they pursue rapid growth and market share. They tend to rely on periodic funding rounds to replenish their working capital. What has happened to these firms? There has not (yet) been a wave of distress or insolvency in the growth segment of the Fintech sector. But Rosenblatt Securities notes that:

"Past market downturns have highlighted that there is an approximately six month lag between a public market downturn and when private market activity starts getting impacted".

This means that, for private Fintech firms, we may start to see the worst impacts of the crisis this autumn or winter. Businesses which did not have the good fortune (or the foresight) to raise money early in the crisis may start to struggle.

Secondly, the economic havoc caused by the crisis has affected Fintech firms differently, depending on their product offering. Put simply, lockdowns and social distancing are hurting some Fintechs and benefitting others – or, at least, hurting them less.

The incumbent institutions, banks and technology firms are generally well-diversified, in addition to being well-capitalised – in fact, many technology firms with "fintech" or "embedded payments" businesses do not really rely on financial services products for margin at all: the real upside for them is the acquisition of user data. By contrast, specialist Fintech firms tend to offer a smaller range of services – often extremely well, with a superb user experience. But this makes them more exposed to the particular ways in which the crisis has affected the broader economy: some activities have been completely shut down, whereas others have boomed.

In the last six months, business-to-consumer Fintech firms have been worse affected than business-to-business firms. Some B2C firms are amongst the best-known in the market, with significant brand recognition and goodwill. But they often rely on transaction-volume based revenues, which decreased significantly during lockdown. By contrast, B2B firms with longer-term, subscription-based revenues (such as technology service providers which provide the underlying infrastructure for the Fintech ecosystem) have been less badly affected.

The following table demonstrates some of the dynamics:

TYPE	COVID-19 HAS HAD DAMAGING EFFECTS ON THE FINTECH SECTOR...	BUT THERE ARE SOME POSITIVES.
Incumbent institutions	Some listed institutions faced significant share price pressure, and are continuing to trade well below pre-crisis levels, despite some recovery from the lows of late March. Many consumers have been forced to make use of their deposits and savings, due to redundancy or furlough – although most incumbent banks have been able to absorb pressure on their regulatory capital.	Existing customers have been forced to download incumbent firms' apps and use mobile/online financial services for the first time-including late-adopter customers who preferred to bank in-branch. This has diluted some of the competitive advantage which challenger firms have obtained, with their early – adopting digital native customers.
Challenger banks	Withdrawal of deposits is more of an issue for smaller banks, which have smaller customer bases with smaller deposits. If the crisis continues into this winter, some firms may start to experience capital pressure. Some challenger banks have a "marketplace" model, which relies upon customers buying financial (or other) services via their app. Revenues from these models have decreased sharply during the crisis, as consumers have not been as willing (or able) to spend as much money. Finally, lockdown and the resulting economic contraction has made it harder for these businesses to grow their customer numbers and deliver on their business plans and projections.	Challenger banks are digital-first, and their user experience (including the ease of opening a new account) remains ahead of the curve. The pandemic is forcing consumers to switch to mobile/online banking for the first time, and this has driven business to the challenger banks.

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Payments firms	Retail point-of-sale volumes have been massively depressed by the closure of physical retail shops during lockdowns, which has depressed revenues for POS firms. Consumer spending has also been lower generally, as people have suffered lost wages, or been unable/unwilling to spend their wages – particularly on one-off, big ticket items like holidays, home improvements and cars. This has reduced revenues for card services providers and other participants in the payments ecosystem.	By contrast, online/mobile digital payments have increased significantly, due to the huge rise in e-commerce during the pandemic. The lockdowns have accelerated the extinction of cash: ATM use has decreased at least 30% year on year[1], and many ATMs have been closed for good. Consumers who had not previously relied on contactless/mobile payments are now willing to do so – particularly following increases in the limits on contactless payments.
Alternative lenders	The decrease in central bank interest rates (and the return of quantitative easing in some cases) has put further pressure on net interest margins, making it harder for lenders to make profits. Many consumers have been forced to borrow money – but discretionary borrowing has decreased, given the loss of earnings and/or uncertainty about the future. Lenders are facing higher defaults (both from consumers and from businesses) and are being required to increase their provisions, which in time may put pressure on balance sheets. Lenders have been forced to adapt quickly to unprecedented credit conditions, which has created challenges for them operationally, and in terms of personnel.	Small businesses are desperate for capital, and alternative lenders have played an important role in disbursing government support schemes – such as the CBILS loan scheme and Bounce Back Loans in the UK. Fintech lenders have been well placed to do this, given their expertise in automated or rapid underwriting and borrower verification. This has shored up some lenders revenues, and their balance sheets (given the government guarantees of many of these loans).

Of course – whatever a firm's product offering, it will be worse-affected if it is incurring significant losses (and cannot raise sufficient new capital to address the impact on working capital), or if it has a weak cash or cashflow position. A survey by BCG found that only 15% of such firms had sufficient capital to survive beyond 12 months.

This means that the ability of growing Fintechs to continue to raise capital in the next 6-12 months – or to enter into M&A activity or partnerships – is key to assessing the future of the sector.

1. RBC Capital Markets – research note.

Funding the Fintech sector

The Fintech sector has been very well-funded over the last decade. More than $200bn of venture capital has been invested in global fintech since 2010- a significant proportion of all venture funding globally. And Fintech's share of VC investment rose from 10 per cent. in 2010 to 16 per cent. in 2019[2].

Will this continue? It is well-reported that global PE and VC investors have record levels of investable funds – around $1.5 trillion- so there is no lack of capital.

Recent UK data from Innovate Finance are fairly positive: VC investment in UK fintechs totalled US$1.84bn in the first six months of 2020, for example. This was a 39% drop compared to the first half of 2019, which is not surprising. But this figure was actually an increase on the level of funding in the second half of 2019 – so the figures are not disastrous.

Interestingly, more than half of that UK funding went to Revolut, Checkout.com, Starling Bank, and Thought Machine – all of which are well-established, well-known businesses. Other Fintech firms which have raised significant funding recently include Germany's N26 (which closed out its $570m Series D round in May), TransferWise (which has recently announced a $319m equity fundraising round), LendInvest (which closed a £285m securitisation in March) and – on the VC side – Atomico, which raised a $820m fund in February 2020.

This reflects a change of focus in VC funding in the Fintech sector: away from early stage businesses (for example, at Series B or earlier), and towards established businesses with a proven model (even if they are not yet profitable).

This shift had already started before Covid-19: the sector is maturing, winners are emerging, and so there is less incentive for VCs to take the higher risks that come with early-stage funding: market share has already been allocated, to an extent. Covid-19 has accelerated that shift: as we've seen, successful and diversified Fintechs are weathering the storm well. So, it is natural that VCs should gravitate to proven businesses, especially as valuations soften and the "bump" between funding rounds decreases – or even results in down-rounds, in some cases.

What will happen to other, less-proven businesses? According to Rosenblatt:

"Reduced funding for fintechs could force firms to seek collaboration, investment or acquisition by traditional financial institutions, PE funds or even non-strategic financial buyers".

It will be interesting to see whether governments will step in, in the longer-term, to fill any gap left by reduced early-stage VC funding. During the crisis, governmental investors (such as the UK's British Business Bank) have become more involved in funding the sector; for example, by means of the UK's "Future Fund". This was designed to address gaps left by other support programmes, which were not generally available to unprofitable, recently-established businesses. If governments wish to retain their "start-up scenes" in the longer term, they may need to consider deploying such support in the longer-term and, for regulated in businesses, doing so in ways which support firms' regulatory capital positions (which the Future Fund, for example, did not).

US$1.84bn

Venture capital investment in UK fintech in the first six months of 2020

2. Crunchbase: Fintech Spotlight.

The role of the regulators

Regulators are also turning their attention to how Fintechs are funded. This is part of a trend that was already starting to become evident before the pandemic; as the Fintech market has matured, and new entrants have taken an increasing share of the market, the focus has started to shift from supporting increased competition to ensuring Fintechs are able to make the transition to a sustainable long term business model.

For many regulators, Covid-19 has highlighted the tensions between the tech start-up model (focussing on growth rather than profit, with regular fundraising rounds) and the traditional prudential supervision of financial services firms (which generally assumes profit as the key driver and less frequent fundraising). And the consequences of the Wirecard investigation (including, in the UK, a temporary freeze on access to consumers' cash) have focussed minds on the potential implications of the insolvency of an important sector participant.

These tensions are not necessarily irreconcilable, but regulators are increasingly feeling the need to be more vocal about their expectations, with much of the focus on issues relating to financial and risk management.

For example, in the UK the Prudential Regulation Authority has recently published a consultation paper aimed at ensuring new banks provide "greater clarity over the path to profitability", including an expectation that profitability will be achieved within a specific timeframe (such as five years). Similarly, the UK Financial Conduct Authority has taken a number of steps since the start of the pandemic to ensure that payments firms are complying with rules designed to safeguard customer money in the event of the firm's failure. We may also see greater focussing on outsourcing as a potential source of systemic risk.

No-one – including regulators – thinks it is possible or desirable for there to be a "zero failure" model for financial services firms, but many fintechs will come under increasing scrutiny in respect of both the sustainability of their business model and their ability to fail safely and with minimal customer harm if their plans do not succeed. Fintechs that play a role providing "utility" financial services, such as banks and payment firms, are likely to see the greatest increase in supervisory interest from regulators. For example, in Europe, the re-launched European Payments Initiative seeks both to reduce the fragmentation of the payments market in Europe – and to reduce reliance on a small number of major card schemes

Overall, Fintech sector participants should expect more attention from their regulators in 2021 and beyond – and should plan to be more pro-active in engaging with them, in order to achieve the best possible outcome.

In the meantime, we expect the changing landscape for funding in the Fintech sector to drive transactional activity. Goldman Sachs has previously predicted three phases of development in the Fintech sector: (1) the emergence of large numbers of start-ups, (2) incumbents reacting by seeking to build their own competing capabilities, and (3) collaboration and consolidation. Now that the largest start-ups are themselves becoming "incumbent", and funding conditions are tightening at the start-up end of the spectrum, and areas of distress are emerging in some sub-sectors, the Fintech sector is accelerating even more rapidly into its third phase. What will this look like in practice?

Digitisation, consolidation and co-operation

The crisis has put a premium on digitisation, and has been far kinder to businesses which are digital-focussed. Digitisation was already a board agenda item for financial services firms, but it is now a top priority.

So, how will firms react to Covid-19? We expect to see opportunistic, strategic, and defensive deals – and the outcome will depend on where the firm sits within the ecosystem.

First, incumbent firms may seek to sell non-core businesses in order to raise capital – and use it opportunistically to "buy digital", by acquiring minority or controlling stakes in popular challengers with attractive technology. For example, Amex acquired the technology of tech-enabled lender Kabbage – while leaving behind Kabbage's loan book. And Metro Bank's acquired the UK's RateSetter, providing access to the latter's peer-to-peer lending platform.

Secondly, well-capitalised challenger firms may be acquisitive, opportunistically or strategically. For example, Revolut announced its interest in acquisitions in March this year, having raised significant funds in an equity round shortly before the Covid-19 crisis began.

Third, growing Fintech firms may seek a sale, if their founders can countenance it: private valuations may not recover quickly, and founders may consider that a sale to a digitising incumbent (or a PE) for cash now may be the best outcome, particularly if the IPO market remains unattractive.

Fourth, established businesses will, defensively or strategically, combine with each other to build their market share, product offering or geographical reach, which will result in significant transactions: examples of this include Visa's acquisition of Plaid for US$5.3bn, and Intuit's acquisition of Credit Karma for $7.1bn. In the UK, two of the leading equity crowdfunding platforms, CrowdCube and Seedrs, have recently announced their intention to merger, subject to regulatory approval.

And fifth, firms will increasingly partner with each other strategically: incumbents and technology specialists (for example, Lloyds Banking Group and Thought Machine, Tide and DueDil); banks and distributors (eg CYBG and SalaryFinance); banks and payments firms (eg Monzo and TransferWise; Tide and ClearBank; OakNorth and ClearBank), BigTech and financial technology specialists (Facebook/WhatsApp and Cielo, Uber and Flutterwave (to launch Uber Cash in Africa).

All of this will also be accelerated by open banking, which is mitigating some of the data-advantage possessed by the incumbent banks – creating a greater need for them to partner.

Some have suggested that we should refer both to "FinTech" and to "TechFin".:

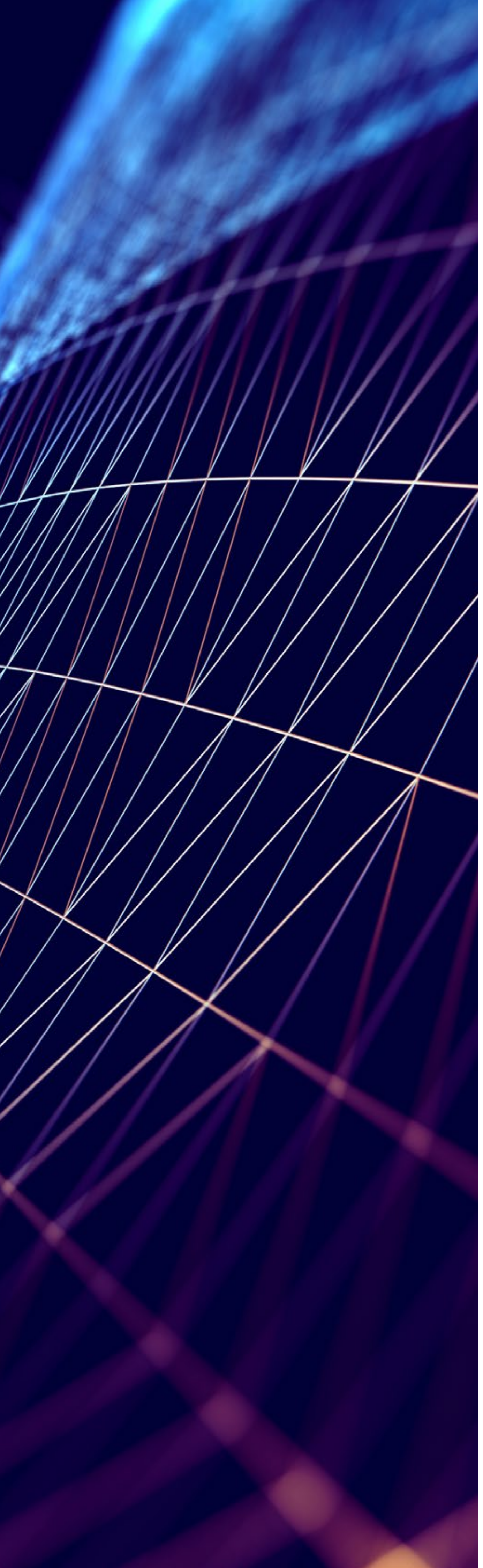
In short, each side wants to benefit from the other. According to this construct, the "TechFins" earn their margin elsewhere, so they are interested in financial services mainly for the data. The challenges of being a regulated business are less attractive to them. By contrast, the "Fintechs" (both incumbents and challengers) cannot match the R&D spend and technology of the "TechFins", and so want to access the TechFins' enormous customer bases and global footprints.

The challenge for Fintechs will be scale and capital. The challenge for Techfins will be addressing regulatory requirements and compliance. **This is why we will see ever more, and ever more significant, M&A and partnership deals.**

> "An important outcome of COVID for fintechs may well be the continued acceleration of partnerships with financial institutions, which can offer the benefits of capital, distribution, access, and compliance infrastructure, but which often lack highly sought-after digital solutions".
>
> **DELOITTE**

> "The TechFins are the technology companies who embed financial services to make their own products more attractive, but whose business model does not depend on margin in those financial services (for example, Amazon). The fintechs are companies who embed technology to make their own products more attractive and whose business model depends on margin in those financial products."
>
> **FORBES**

> "The pandemic has really accelerated fintech development – we're seeing not only more partnership dialogue, but also more mergers and acquisitions activity."
>
> **JEFF GIDO, GOLDMAN SACHS**



2021 and beyond

The use of technology in financial services is nothing new. Financial institutions have used computing to seek a competitive edge for decades: since the early days of IBM in the 1950s, and the introduction of ATMs in 1967.

But the Fintech sector as we now know it started to develop rapidly in the second half of the 2000s, following the Global Financial Crisis. This occurred for a number of reasons, including the regulatory response to the crisis (which often included an explicit promotion of competition and of new entrants), the fiscal response to the crisis (low or negative interest rates, plus tax incentives for venture investment), the availability of highly qualified staff (following redundancies from the major banks), and technological advances (including the greater availability of cloud computing, which reduced barriers to entry – and, of course, the move to mobile, including the launch of the first iPhone in 2007).

All of these factors combined to lead to an explosion in creativity and growth, and to what we now call the Fintech sector.

And all of these factors are applicable today. Regulators are supporting firms through the crisis, quantitative easing has returned, talented people are seeking work, and we are achieving new breakthroughs in AI and machine learning.

This, combined with the push to digitise which has resulted from Covid-19, means that Fintech is beginning its next phase. Challenges remain, of course. Economies around the world are likely to remain depressed for some time, until the Covid-19 crisis has abated and for some time afterwards. This will continue to affect revenues, funding, and activity in the sector. In the UK and Europe, the effects of Brexit will start to be felt fully from next year, and this will affect the financial services industry as much as any other. And the Fintech sector will also need to address challenges of its own making, such as financial inclusion: how will societies cope with such a rapid step-change in the move to mobile, and the move away from physical cash? Will particular demographics be disadvantaged by these developments?

The Fintech sector is agile, adaptable and ambitious. It arose out of a global financial crisis, and has been central to recovery from the current pandemic. Despite all of the current challenges, we believe that the Fintech sector is well-placed for the next decade. We look forward to the next stage of the journey.

The authors wish to thank Mike Carter and Marco Meier for their assistance in producing this article.

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