Investment Banking – FinTech Viewpoint

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REBUNDLING FINANCIAL SERVICES

FinTechs Go Multi-line in Act II Of Their Growth

In Act 1 of their growth (circa 2012-2013), FinTechs selected one product or service from an incumbent's integrated offering, and began offering it digitally either at significantly lower cost, or with a better UI/UX. In Act II, prominent FinTechs are expanding beyond their original beach head, adding products, and going multiline. What's driving this? Our research indicates the drivers are growing constraints on organic growth, a financial need to monetize customer acquisition costs (CAC), and customer demand to rationalize the number of provider relationships. At the same time, there is much greater technology available allowing FinTechs to go multiline: *banking-as-a-service* platforms that enable rebundling, the wide availability of APIs that make service integration easier, and enabling technology like Cloud, AI/ML and advanced analytics.

Aggregation of multiple services and offering them under a single brand or via an integrated product set is not a new concept in finance, incumbents have been doing that for years. But modern day rebundling by FinTechs is different than the traditional incumbent-driven super market approach. It involves bespoke services tailored for a customer's lifestyle, better attuned to her needs instead of mainly motivated by the provider's interests. FinTech rebundling is more rapid, dynamic and personalized, and providers are able to achieve this through partnerships, or by using second generation APIs to 'serve up' solutions (e.g. Stripe for Payment, Plaid for Data, Xignite for Market Data).

Two Major Drivers

Monetizing client acquisition costs is the #1 driver for FinTechs to rebundle new services. FinTechs burn extensive amounts of capital to acquire customers which must be monetized to gain financial leverage. Equity owners in FinTechs want their capital to be efficiently utilized by the FinTech by cross-selling new services to current clients, than incurring costs to recruit additional clients for the original service. In our banking experience, a FinTech's valuation enjoys a "bump up" as it rolls out additional services, as valuation is some function of its life time customer value divided over its customer acquisition costs (as illustrated). When a FinTech offers additional services to existing customers, the life time customer value increases, while the customer acquisition costs remain almost the same as the new services are sold to current customers. That enhances the FinTech's valuation, all else remaining equal.

Valuation also gets boosted as multiple services offered by the same Fintech increases the level of customer stickiness which in turn drives up life time customer value.

A FinTech's valuation is a function of its Life Time Value of customers, divided by Customer Acquisition Costs

$$\text{Valuation} = f(\underbrace{LTV}_{\text{Life Time Value of Customer}} / \underbrace{CAC}_{\text{Customer Acquisition Cost}})$$

The second impetus to rebundle is growing customer need for integrated services provided by a small number of providers. Customers overwhelmingly want to consolidate financial relationships and be able to see their financial situation through a single pane of glass. Accessing separate providers for different services is considered inefficient, onerous and inconvenient.

People were willing to buy services from different FinTechs a few years ago, when the gap between what a FinTech offered and an incumbent was very wide, and there was a novelty factor in buying a FinTech's service. But both these factors have become less relevant as incumbents have narrowed the functionality and cost gap with FinTechs, and some of the excitement among clients of using the shiny new FinTech product has worn off.

Multiple Strategies Are Being Employed

- Launching new services inhouse, is the most popular rebundling strategy among FinTechs. But only firms with solid brand recognition, maturity and ability to acquire domain knowledge are able to do this successfully
- Using APIs to connect with other providers is a fast evolving strategy with great potential to expand as APIs mature. It will create powerful partnerships between financial providers and other industry participants to offer new solutions.
- "*FinTech or Banking as a Service*" platformification is the most interesting strategy, but more likely to be employed by financial institutions, that have the resources to build a full scale platform that supports other providers who offer their own services.

Taking Stock Of Early Lessons

- The best rebundled service candidates have network affects and go viral. These include two side marketplaces and platforms that can scale.
- Services with a high cost of goods sold make less sense to add, as they drive down contribution margin. That means pure transaction-based services like payments are better as add-ons than lending-type services that involve undertaking risk or require significant capital.
- Demand deposit accounts (DDA's or Checking accounts) are the most popular services being added by providers, with FinTechs eagerly trying to 'capture' the customers' paycheck. DDAs are the nerve center of the retail customer's financial life, and firms who can control those funds enjoy market power and customer stickiness. Not surprisingly, FinTechs from either direction – investments and payments – are busy adding DDAs, which pitches these firms as competitors

- There are 10x the amount of rebundling efforts underway in the retail market than in B2B. That makes sense, as scaling up to serve enterprises is considerably harder than serving retail customers. But we do expect more B2B rebundling efforts to emerge in time
- Core consumer banking is seeing the most rebundling, followed by payments and lending, and lastly capital markets. Insurance is somewhere in the middle, with P&C firms beginning to add L&A services.

Where Incumbents Went Wrong, And FinTechs Must Watch Out

FinTechs must avoid the strategic mistake that financial institutions have made in aggregating multiple services in the past. Institutions forgot (often chosing to ignore) customer needs and instead rebundling efforts were purely driven by self-interest (create stickiness, maximize lifetime customer value), than the interests of the customer. Smart FinTechs seem to have studied incumbent history and are adding new services focusing on the customer's core needs, than their own. But facing margin pressure and growth expectations, can make even the most resolute FinTech go down the incumbent's path. Wise FinTechs would pay heed to this warning.

Here Comes BigTech

FinTechs are not the only players rebundling. US BigTechs (Facebook, Amazon, Google) are integrating Payments and Lending into ecommerce offerings, somewhat copying their Chinese counterparts (BATs) that have smartly woven financial services into their core ecommerce value chain. But for both US FAANGs and Chinese BATs, adding financial services is not an attempt to become regulated financial entities, but a carefully planned element of serving their customers by integrating financial services at the right time, conveniently and cheaply. Financial incumbents and FinTechs may seem to compete with BigTechs head on while offering these services, but the intention and operational strategies are very different. In fact, we think FinTechs may actually have an opportunity to partner and provide financial services to 2nd rung ecommerce players (retailers like Target, electronic stores like BestBuy) who may not possess the ability to build such services inhouse.

Funding and Investment Banking Opportunities

While still at an early stage, we expect rebundling to drive considerable investing and deal making. Some FinTechs will throw in the towel at organically building services inhouse and acquire smaller, focused, service providers. Other FinTechs will raise more rounds of capital on the back of higher valuations, to develop new services. Rebundling will not just be a FinTech game, leading financial institutions and traditional providers (FIS, Broadridge, Bloomberg) will position themselves as a financial platform on which they invite third party FinTechs to aggregate multiple services. That is bound to drive market activity through partnerships, co-investments and some M&A. Bottom line is: keep an eye out on FinTech rebundling, we surely are.

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