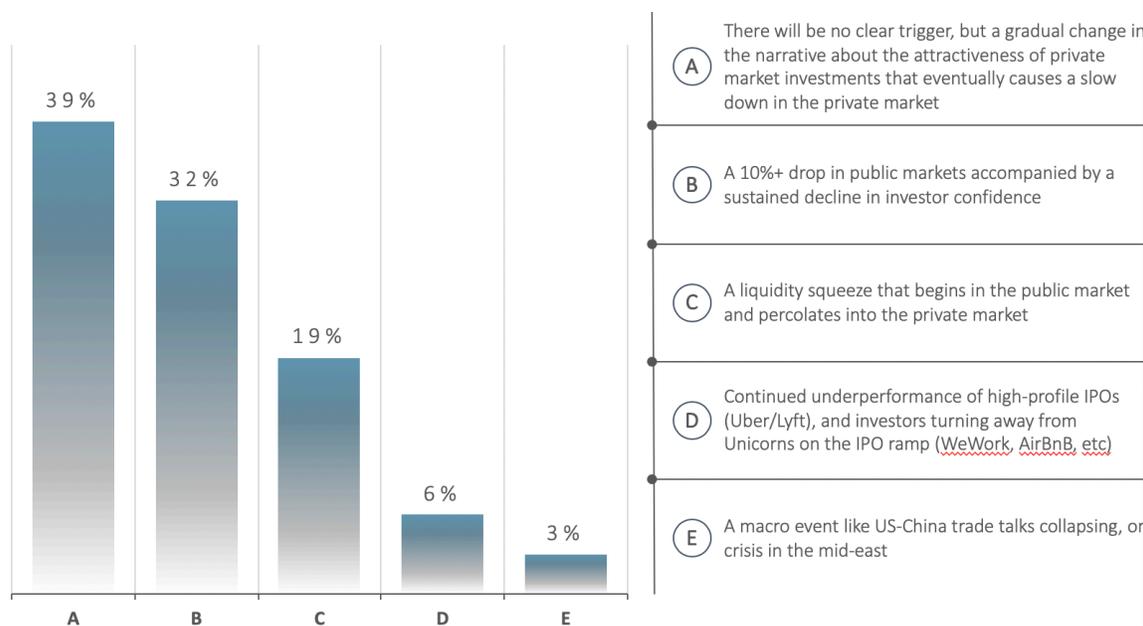


## Looking Ahead To FinTech In 2020: What If There Was A Slowdown? Investor Survey About A Potential Turn In The Private Market Cycle

With major IPOs in 2019 struggling and high-flying Unicorns (WeWork, AirBnB) having delayed plans to go public, 2020 could bring uncertainty to the private FinTech market. After 10 years of a private market boom, valuations are stretched and macro risks are building up. Could 2020 herald a slowdown in private FinTech: lower valuations, tougher conditions for raising capital, down rounds, pressure on startups to reduce burn rate, and investors pushing portfolio companies to fast track profitability? Rosenblatt Securities surveyed top investors (VCs, PEs, Corporate Venture Capital) to capture their thoughts on how they would navigate a turn in the private market cycle. Rather than asking investors about the probability of a downturn or the timing of when it may happen, our survey focused on how investors would act, what impact it would have on valuations, exits and investor sentiment.

Here are 7 major findings from our investor survey and our analysis.

### What could be the most likely trigger for the FinTech cycle to turn?



**1. Investors believe a slowdown will not be triggered by a single event, but a gradual change in the narrative about the attractiveness of private investments that eventually causes a slowdown**

Investors don't foresee a single factor or a clear event that triggers a slowdown or a downturn in the private FinTech funding market. 39% of investors said they expect a slow down to gradually materialize over some time, following a sequence of events that may seem inconsequential but which eventually begin to drag investor sentiment down. The dismal performance of high profile IPOs and some getting pulled from the schedule altogether due to market turbulence could gradually shift investor sentiment away from private FinTech funding. Another 32% of respondents said a 10%+ drop in the public market accompanied by a sustained decline in investor confidence could have a knock-on effect on the private market. Indeed, the last two major declines in private markets (2001, 2009) were partly triggered by public bear markets.

**2. 65% of investors believe Unicorns will experience the biggest valuation drop, followed by early-stage (Series A-B) FinTechs. Mid-stage firms will fair the best**

Investors believe that FinTech Unicorns will experience the hardest hit to valuations across the capitalization table, followed by early-stage companies. This sounds counter-intuitive as a stressed market usually causes a flight to safety and one would think late-stage companies are safer investments due to their size and scale. Our explanation of this survey response is that a few FinTech Unicorns have been trading at stretched valuations who may experience an outsized decline in valuation in a softer market environment. Investors further said that the average FinTech Unicorn's valuation could decline 20%, wiping out almost \$76 billion in aggregate FinTech Unicorn market capitalization. The survey says that mid-stage growth companies (Series B-D) would fare the best probably because as they approach escape velocity, they can keep attracting funding even in a slowdown as long as they can demonstrate that their business models can scale. Finally, investors believe that early-stage companies (Series A and earlier) would also face heightened pressure due to greater risk aversion and the execution risk for unproven businesses.

**3. Lending will suffer the greatest drop followed by Capital Markets, while Insurance and Payments will be least impacted in a downturn**

Among the four major FinTech sectors (Payments, Lending, Investments and Insurance), Lending will be hit the most in terms of valuation, funding, exit prospects, etc. Payments will survive the best while the impact on Capital Markets and Insurance will fall somewhere between Lending and Payments. That makes sense as Lending FinTechs are balance sheet-intensive businesses, which are highly sensitive to economic cycles, unlike Payment companies whose value is mostly driven by operational needs that are much less sensitive to market downturns. Capital Markets FinTechs also would come under pressure as financial institutions shift their focus from growing top line to managing expenses.

**4. Top two investor concerns are that a down cycle will make raising new funds difficult, and "winning" investments will suffer collateral damage**

Investors are most concerned that a slowdown will hurt their ability to raise new funds. That sounds obvious, especially if the public markets underperform. LPs would reduce allocations to private investments due to heightened risk, a higher illiquidity premium, and because lower public market valuations push their private market value to exceed its target allocation. The second challenge is

more subtle. In a downturn, even good companies get marked down and experience trouble raising additional rounds along with marginal players.

### ***5. 77% of investors say they will be opportunistic if valuations drop, and they have their shopping lists ready***

A vast majority of investors describe their attitude in a soft market as being opportunistic buyers. They would be ready to use their “dry powder” in FinTech sectors like consumer finance where valuations have been markedly high in recent years sidelining all but the most bullish investors. While this sounds rational, it seems implausible that 77% of investors would be eager buyers. That is a lot of buying pressure and there probably won't be adequate inventory to satisfy investor demand.

### ***6. Investors are open to marking down investments and exploring unconventional exits if a slowdown occurs***

The next question we asked was about private exits in a downturn. In case of a public market downturn when the IPO market almost shuts down but for the most compelling companies, investors would be willing to mark down positions to account for the corresponding public market decline. Next, they would explore unconventional exits like merging portfolio companies with similar firms or entertain an exit to unconventional buyers (e.g. sell to non-financial strategics such as Google or Amazon, etc.)

### ***7. Investors will more closely manage portfolio investments to reduce burn rate and encourage portfolio company CEOs to fast track profitability***

When we asked investors what their top priorities would be in managing their portfolio, 84% said their #1 priority would be actively working with portfolio companies, doing scenario planning of what each company needs in a weakening private market. Forced to conserve capital amidst a fundraising squeeze, VCs would also ask portfolio companies to reduce their burn rate and move faster towards profitability. Another 10% of investors said they have (or would) study past downturns and take lessons how to manage investments if market conditions began deteriorating. A smaller percentage of respondents said they would maintain much closer contact with GPs and co-investors to ensure coordinated action in a downturn.

## **Other Implications Of A Downturn**

Outside the survey, conversations with investors and our market experience reveal several other implications of a downturn. Private market downturns often follow a public market swoon, albeit with a 5-6 month lag. If there is a downturn in public equities, valuations and multiples would contract, leading to smaller potential exits which in turn would mean VCs requiring lower valuations to achieve the same return. This would enable VCs to conduct more flat or even down rounds for companies that are struggling to get traction and build scale in a downturn.

The investor's attitude could rapidly shift from finding suitable investments and deploying capital, to conserving capital on hand. This means tougher funding conditions for entrepreneurs including down rounds, smaller funding rounds, stricter corporate governance, and tougher terms for raising capital. Marginal players would get sidelined accompanied by a flight to quality. Investors would also be less willing to fund early-stage companies that pose a higher risk, preferring to use their capital to double down on later stage or more established portfolio positions.

Investor confidence matters even more in private markets than in public equities due to weaker liquidity and concentrated power in the hands of a few investors. Investor confidence in the private market is also very fickle due to a lack of transparency, illiquidity and tremendous information asymmetry. So the slightest threat of market softness makes investors *want to* rush for the exits causing enormous selling pressure even. It's the opposite of what we have witnessed in the last few years when influential institutional investors like SoftBank bid up valuations unleashing an investing frenzy. But a downturn may cause the investor sentiment to flip polarity quickly. That's what happened in 2000 and 2008 when equity markets got hit, and the contagion spread to investor confidence in the private market. It took a few months, but once confidence in private investments began souring, valuations and funding dropped quickly.

Another distinction is the varying impact of a downturn on B2B versus B2C FinTechs. Our analysis reveals that B2C companies would suffer more than their enterprise counterparts due to less sticky retail relationships, soaring cost of customer acquisition, and more stable business models. B2C FinTechs have had much higher multiples than B2B firms, and that spread in multiples would narrow quickly in a downturn.

Finally, let's consider how a downturn would impact different types of investors. As downturns lead to greater down rounds at lower valuations, the value of the common stock (held by employees and management) declines more than preferred stock (held by institutional investors). That means founders and employees would absorb a disproportionately higher impact of a downturn as their holdings would be devalued more than institutional investors. Employee morale would also decline significantly, which is detrimental to operating the company exactly at a time when they need to hunker down and ride out the storm.

## Closing

It's never fun talking about a market downturn but history's lesson about market cycles is that it is better to ask questions early and be prepared than to wait until the eleventh hour. The time to talk about market correction was 2007, not 2009. Whether we are FinTech entrepreneurs, investors or advisors, it is prudent to be prepared for softer market conditions especially when we are close to the 10<sup>th</sup> anniversary of a boom in private FinTech funding.



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