Investment Banking – FinTech Viewpoint

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EMBEDDED FINANCE – PART 2

The Robust Investment Case For Embedded Finance

Why FinTech Investors Will Remain Busy For The Next 10 Years

EMERGING EMBEDDED FINANCE MARKET MAP

(This is Part 2 of two Viewpoints about Embedded Finance, Part 1 defines the concept and its benefits).

In the first phase of FinTech growth during 2009-2019, investors took stakes in FinTechs that basically did three things: took traditional brick and mortar services and offered them digitally, used emerging technologies or big data to improve traditional financial activities (credit decisioning, underwriting, etc.), or created entirely new products like quantamental investing. But opportunities for FinTech investors will explode over the next five years as financial services get increasingly embedded into other industry offerings, and a new class of infrastructure providers emerge to enable this. The smartest VCs are already executing on this investment thesis and aggressively investing in FinTechs that provide the infrastructure that enables EF.

What investment opportunities does EF create?

There are two ways for investors to participate in the growth of EF.

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- **Invest in technology companies that are creating the founding infrastructure**. I.e., firms that provide the technology for FinTechs and non-financial companies to natively embed financial services. This is a highly lucrative investment opportunity for FinTech investors, as demand grows for infrastructure players that enable EF. Prominent VCs - a16z, Anthemis, Bain Ventures, Canaan Ventures, and Sequoia, are making major investments in such companies. Consider the huge funding rounds at high valuations completed in the last 12 months for a range of companies, including Cross River Bank, Currency Cloud, Finix Payments, Marqeta, MX, Payfone, and SynapseFI.
- **Invest in businesses whose economic prospects are greatly enhanced by embedding services.** As non-financial companies embed services, their investment potential will grow substantially, driven by new sources of revenue or as they benefit through improved customer service, greater loyalty, and lower CAC costs. New industry-specific business models will be enabled that address and serve the special needs of each industry. Examples are Passport, which allows paying for parking meters from any mobile device or Battlefy's platform where content originators, publishers, and brands create online sports competitions. There will be unique investment opportunities in every major industry as firms embed financial services and greatly improve their own investment potential and get accorded high valuations.

EF will also attract a much broader range of investors as it creates fresh, new incentives. Besides traditional VCs interested in taking equity stakes in growing EF infrastructure players, there will be financial institutions and incumbent service providers eager to acquire EF infrastructure vendors for strategic reasons. Case in point: Visa's $5.8 Bill acquisition of Plaid to gain the crucial capability to serve hundreds of FinTechs and non-financial companies that Visa may have struggled to serve alone.

What does the EF market map and broader EF ecosystem look like?

Being an emerging concept, it is too early to define what the market map or the complete EF ecosystem will eventually be. But here are 4 categories of players that will comprise the full EF ecosystem:

- Full-stack solutions: These include end-to-end infrastructure vendors like SynapseFI that offer core transaction processing, but also compliance, banking relationships, and customer service support, all wrapped into a single offering. Other examples are Bond Financial Technologies, Green Dot, and StoneCastle's Cambr platform.
- Focused solutions offering one specific service: Providers that specialize in offering one specific service in the technology stack, instead of multiple services. This could be payments enablers like Finix Payments, data vendors like Plaid, AML vendors like ComplyAdvantage, fraud detection software SentiLink, or firms like Drivewealth that help embed investing services.
- Banks that combine banking licenses and software: This category of firms offer a banking license, may extend their balance sheet, as well as provide the software stack for FinTechs and non-financial businesses to embed financial services. BankMobile, BBVA, and Cross River Bank are good examples.

- Pure play banking institutions: These firms are not direct providers of EF technology but still part of the overall ecosystem that enables EF. Regional banks like Bancorp, Radius and WebBank offer or 'lend' their banking license to non-financial firms so they can embed services that require a regulatory license. More banks are getting into this game, realizing an opportunity to generate revenue by serving firms eager to roll out EF services.

How can investors evaluate/differentiate between the many players in the EF ecosystem?

As EF is still in its infancy with the enabling tech stack under development and providers at an early stage of growth, it creates an opportunity for smart investors to do their homework and identify emerging players early, before they garner broader attention. Here is the criterion investors can use to evaluate providers and differentiate between players across the EF ecosystem.

1. **Breadth of product offering**. What financial products or services does the vendor enable? Traditional Payments and Lending, or even Investments and Insurance?
2. **Banking license, pure tech stack or both**. Some providers only offer a banking license, a tech stack, or a comprehensive offering combining both capabilities
3. **What part of the tech stack does it offer**? Does the vendor offer processing capability, AML/KYC, fraud prevention, data, or customer UI/UX?
4. **Does the vendor offer 24/7 service and support** for the customer's end clients?
5. **What level of industry-specific verticalization or customization does the vendor provide**?
6. **Does it offer its own Core processing**? Or does it link to a 3rd party firm's (e.g. FIS, Fiserv) core processing capability via an API?
7. **What types of customers does it serve**? Other FinTechs, Tech firms, smaller financial institutions, or is it industry-agnostic?
8. **How global are its offerings?** Each region has unique financial service requirements, so EF vendors have to tailor their services by country. For e.g., enabling payments in the US requires very different compliance checks than in continental Europe.

What are the implications of Embedded Finance?

EF will transform the role of finance, making it contextual, convenient and cost-effective. Instead of finance being a stand-alone function, it will get ingrained into the lifestyle of customers, whether it is making credit available at the point of sale or providing insurance during a customer's life event. But as finance gets more *embedded*, it will fundamentally alter the competitive structure of the financial industry. Here are seven implications of the growth of EF:

1. **Competitive power of incumbent financial institutions will weaken**: As businesses in every industry embed financial services in their offerings, they will essentially wedge themselves between traditional banks and their customers as they enable payments, lending and insurance services themselves. This will push traditional financial institutions to the background reducing their brand identity, contracting their pricing power, and further commoditizing them. Prominent non-financial companies (like big tech firms Apple, Facebook, Google) will get further entrenched in consumer's lives, gaining even greater trust, confidence, and influence.

2. **Financial profit pools will shift**: Non-financial companies will chip away at the profit pools that financial institutions and service providers have historically made from processing payments or offering lending. For example, a typical retail transaction has about 300 basis points of revenue that players in the payment value chain (processors, payment facilitators, card networks, sponsoring banks) make from the transaction. As non-financial companies like Uber or Shopify offer payments in house, they may take up to 50 basis points of the 300 basis point fee pool that was available to traditional participants.
3. **New business models will emerge**: EF will enable new business models to emerge just as the Internet or digital finance spawned new opportunities. Examples are income-sharing arrangements (ISA) for student loans enabled by ISA marketplaces like Edly. Or kWh Analytics, which offers insurance for solar energy assets by utilizing data from solar farms to guarantee a minimum amount of energy output. These models will expand the concept of financial services beyond traditional industry boundaries, bringing new players that blend tech and fin more innovatively to serve the unique needs of customers.
4. **FinTech investors will discover new opportunities**: The concept of "FinTech investing" will expand as the definition of what constitutes FinTech broadens and traditional boundaries between industries disappear. As mentioned above, investors will have an opportunity to invest in infrastructure providers that deliver embedded finance (e.g.s CurrencyCloud, Finix Payments, Marqeta, MX) or new businesses that are now possible due to embedded finance (Trov that provides on-demand insurance engine, or Flock that offers pay-per-flight drone insurance).
5. **Consumer choice, convenience, and pricing will improve substantially** as brands people love integrate payments, lending and other financial services into the products and services they provide. Just as ride-sharing greatly improved the customer experience, businesses in all industries will customize financial services to the needs of that particular industry offering, greatly enhancing overall customer experience.
6. **Financial inclusion will receive a shot in the arm**. There will be new ways to serve the unbanked as structural problems that prohibited traditional financial institutions from serving them, get addressed through embedded finance. Expect more firms like Propel that serves 40 million families on food stamps and more developments like faster payment of earned income made possible by FinTechs like Earnin and delivered by firms like Uber. Faster payments are essential to reduce poverty and stop exploitative payday loans.
7. **New regulatory challenges will surface**. EF will create new regulatory challenges and systemic risks as non-financial, non-regulated entities begin providing financial services. Regulators will need to adapt rules and regulations to accommodate these new providers of financial services, walking the tightrope between ensuring financial stability and not stifling innovation or customer convenience.

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