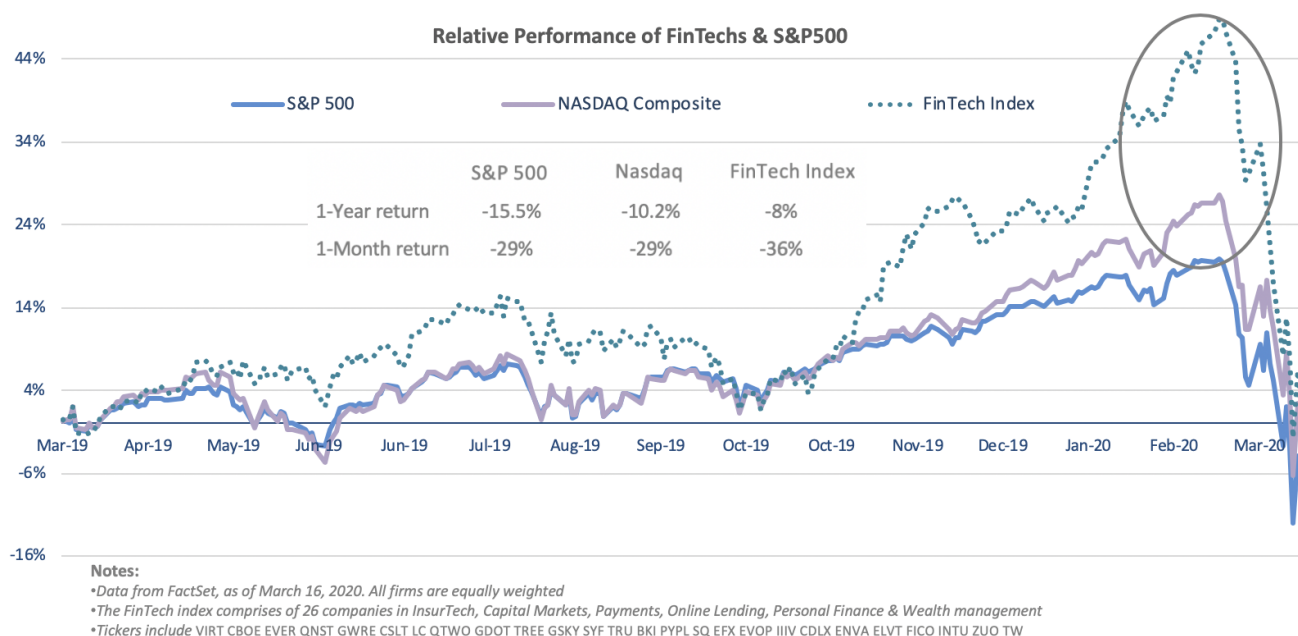


Implications of COVID-19 and the Market Disruption on Private FinTech How Funding, M&A and Valuations May Get Impacted

What a difference one month makes. Public FinTechs were significantly outperforming the S&P 500 and Nasdaq until the COVID-19 crisis hit. On Feb 19th, the FinTech index comprising 26 public firms was up 49%, compared to Nasdaq and S&P 500 being up 28% and 20%, respectively. Since then, the FinTech index has underperformed both the S&P 500 and Nasdaq by 7%. See the chart below.

So how will the decline in public equities and the economic fallout due to COVID-19 impact the private FinTech market? This viewpoint shares our perspective.

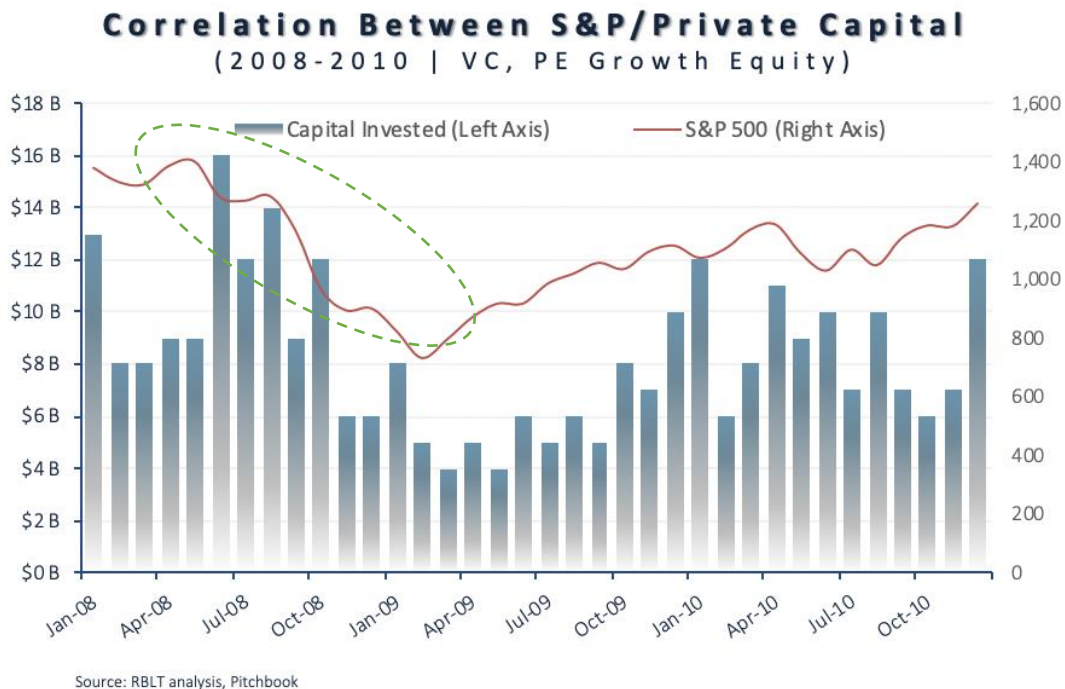


There are three aspects to how COVID-19 and the current disruption in public markets will impact private FinTech companies:

- Business conditions (both demand and supply) may deteriorate impacting a FinTech’s operating performance
- Funding conditions may weaken, jeopardizing growth plans
- Exit options (M&A and IPO prospects may change significantly).

These forces may feed off each other, creating a vicious cycle where deteriorating business performance makes funding more difficult and vice versa, should the market downturn last long.

Past market downturns have highlighted that there is approximately a 6-month lag between a public market downturn and when private market activity starts getting impacted. See the chart below that shows performance of the S&P 500 and private capital invested in the US. There is a high correlation between the two factors and an approximate six month lag between a public market downturn and when signs of distress emerge in the private market.



The VC/PE markets are also generally cyclical, exhibiting 7-10 year booms punctuated with 2-4 year troughs. In cases where public markets recovery quickly from a sudden downturn (the V-shaped recoveries we saw in 2016, 2018), the private markets may be able to avoid any disruption altogether. But a protracted downturn in public equities eventually always infects private markets. While it is too soon to analyze the full impact of the COVID-19 disruption on private markets, if the public market dislocation is any indicator, substantial pain may lie ahead for private investing. The level of pain will depend on both the severity and the length of time that COVID-19 exists, the resulting disruption of trade and commerce, and the extent of the decline in the public market.

ANALYZING THE IMPACT ON PRIVATE FINTECH

Business Performance

A large proportion of private US FinTechs are less than ten years old and facing their first market downturn. So many management teams may be inexperienced in responding to difficult business conditions – weak customer demand, working capital squeeze, and a tougher environment to retain employees.

FinTechs with lower fixed costs will outperform and gain favor with investors over those with big, rigid fixed costs. The flexibility in business models and the ability to dial-up/down costs will become critical for FinTechs and will determine which firms survive. Firms that rely heavily on large marketing expenditures to generate growth will come under investor scrutiny as they can no longer justify large customer acquisition costs (CAC) due to weak transaction volumes.

With VCs and other investors less willing to continue funding weaker FinTechs, and founders unwilling to accept the new market reality, the next few quarters may see subdued overall investment activity. However, good firms with fully-validated business models and solid management teams should continue to attract investor interest.

Competitive Environment

Traditional financial institutions will gain a competitive advantage over FinTechs in this highly uncertain market environment as they are better capitalized, have bigger brands, and benefit from customers becoming more risk-averse. FinTechs with recurring revenue and long term contracts will be impacted less than firms with transaction-based business models.

Consumer-oriented B2C FinTechs (e.g., Challenger Banks) that have been very popular in the last few years will see business performance contract faster than B2B models (e.g., Capital Markets, Corporate Banking, Treasury). This will be a reversal of a clear trend in the last few years when investors had a preference for B2C over B2B FinTechs.

Funding Conditions

According to Pitchbook, PE and VC firms had a record \$1.2 trillion of cash or dry powder in Nov 2019, so FinTechs with solid value propositions and credible management teams may not experience an immediate constraint on funding. Rosenblatt was prescient by surveying top FinTech investors in October 2019, asking them how they would react to a market downturn and how it would impact valuations. 55% of investors said they would be opportunistic and stand ready to fund or acquire FinTechs if valuations dropped, especially in sectors like consumer banking that had become unaffordable during the recent FinTech bull market. Our investor survey findings are covered in a [Viewpoint](#) and a [webinar](#) available on our site.

But if the market downturn stretches into the Fall, the investment committees will become much more discerning about who to continue funding and who to “let loose” as they seek safety with “flight to quality.” Deal structure and deal terms will shift in favor of investors. Liquidation preferences will likely climb up from the 1x during good times to 2-3x amidst a protracted slowdown. Anti-dilution clauses may also become more common, with the introduction of more stringent terms that recent term sheets didn’t have.

Some LPs of venture capital and private equity firms may start dialing down commitments, negatively impacting their fundraising plans. For a particular class of institutional investors (endowments, foundations, pension funds) who are required to maintain a particular allocation to private investments, a contraction in their public holdings would push up the percentage of their private allocations, which are being held at book value. This would require them to either: 1) write down

their private market holdings to fair market value, or 2) liquidate some part of their private portfolio to bring allocations back in line with the required percentage.

M&A

Reduced funding for FinTechs could force firms to seek collaboration, investment, or acquisition by traditional financial institutions, PE funds, or even non-financial strategic buyers. The blistering pace of FinTech M&A in the last six months with incumbents buying FinTechs (Visa/Plaid, Intuit/Credit Karma), FinTechs buying banks (Lending Club/Radius Bank), and traditional firms combining for scale (Aon/Towers Wills, Morgan Stanley/ETrade, Charles Schwab/TD Ameritrade) should accelerate if the slowdown continues. Not surprisingly, deal terms will swing in favor of acquirers.

When VCs made FinTech investments in past years, they depended on a vibrant IPO market as one of the avenues for liquidity. But with IPOs markets tightly shut at least for the next few months, exits via strategic M&A might be the only option available for liquidity.

Online Alternative Lending, Digital Wealth Management, and Consumer Banking are sectors most likely to see M&A deals as incumbents use stronger balance sheets and wider distribution to buy FinTechs, especially those with unique IP, great products, or access to new customer segments or markets. Company boards and investors may be more open-minded in entertaining such strategic dialogues that were not necessarily on the agenda until now. Who will buy these FinTechs? Strategic buyers may emerge, including financial institutions, tech firms, and foreign buyers.

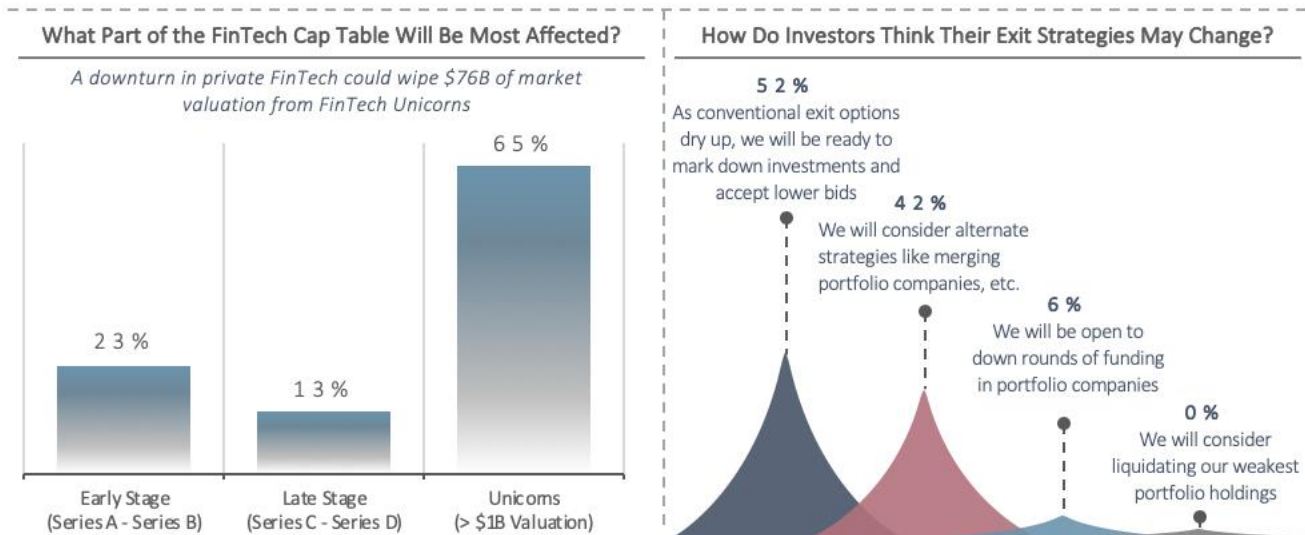
Valuations

Historically, private market valuations have been impacted when public markets have remained dislocated for at least two quarters. So unless the current slowdown lasts through the November election, private market holdings should not see meaningful write-downs, at least for healthy FinTechs that don't need immediate funding.

The "top-line growth at all cost" mindset already took a hit in 2019 as investor sentiment slowly began sully about firms using cheap VC capital to drive customer growth. The current market uncertainty may accelerate this trend, causing a sharp reversal in investor sentiment and reducing, if not nearly eliminating, the number of outsized rounds being done at sky-high valuations. We think the "bump up" in FinTech valuations between rounds will also decline. The bump up we have seen between funding rounds may flatten out or even contract significantly in cases of down rounds.

In our Oct 2019 survey about a market slowdown, investors said they expected the 58 FinTech Unicorns globally (as of Oct 2020) to be most impacted, with average valuation contracting by about 15%. With the market capitalization of the 58 FinTech Unicorns being \$510Billion at that time, that implies, a protracted downturn could wipe off \$76 billion of Unicorn market value. The next segment to feel the pain and suffer declining investor interest would be early-stage companies (Series A and prior) that have yet to fully validate their business models. Series B-D companies would fare better than their less-mature peers and could trade at par or even at a reasonable premium if they can demonstrate healthy growth, have unique IP and resilient business models.

The charts below illustrate what part of the FinTech cap table investors feel will be most impacted (left) and how investors feel their exit strategies may change (right).



Source: Rosenblatt Banking Survey of FinTech Investors, Oct 2019

IMPACT ON DIFFERENT FINTECH SECTORS

There will be major differences and nuances in how FinTech sub-sectors respond to a distressed market. Our analysis indicates that Lending FinTechs would suffer the biggest drop (lower valuations, slower funding), followed by Capital Markets. Insurance and Payments would be less impacted. B2C FinTech models (e.g., Challenger Banks) that have been very popular in the last few years will see valuations contract faster than B2B models (e.g., Capital Markets, Corporate Banking, Treasury).

Here are salient points about the impact that will be felt by different FinTech sectors.

Challenger Banks

Declining business activity, a weakening economy, and tight funding conditions will especially hurt Challenger banks. With the Fed reducing the benchmark interest rate to zero, Net Interest Margins (NIM) for Challenger Banks will get more compressed than traditional banks as they rely heavily on transaction revenues, which will decline amidst the COVID-19 lockdown. Making matters worse, the cost of funding for Challenger banks may not reduce proportionately to lower Fed rates, and less than that for incumbent banks, weakening their competitive position. The only positive trend for Challenger banks in the current climate will be a higher demand for digital interactions as customers have restricted mobility and can't access traditional bank branches.

The trend of rebundling multiple banking, payments, and investment services should accelerate even further, driven by the need to monetize customer acquisition costs. Rosenblatt has extensively covered the rebundling theme in our banking [Viewpoints](#) and during our 2019 [FinTech Summit](#).

Online Lending

Digital lenders could be entering into a perfect storm of lower net interest margins, falling loan growth, rising delinquencies, and defaults. The 3.6% YoY growth in 2019 for all loan balances at US banks (FDIC data) will almost certainly flatten due to the economic lockdown. Lenders that had begun serving subprime and small/medium businesses (SMB) due to competition for prime

borrowers may see default rates rising and discover they have inadequate reserves. The algorithms of Alt lenders using alternative data to underwrite risk and make loans will be severely tested for the first time. Plans of newer online lenders like LendInvest and Zopa, who were hoping to exit via an IPO, will be delayed indefinitely while the first generation of FinTech lenders (Lending Club, OnDeck) come under pressure once more.

Robo Advisors/Digital Wealth Managers

Severe volatility and the lack of recovery in public stocks may scare away all investors, especially millennials, who are the biggest customer segment for robo advisors. Self-directed investors using robo advisors and online trading platforms may gravitate away towards established wealth management shops (Charles Schwab, Fidelity Investments, Morgan Stanley) who have matched the “zero commission” model of e-Brokers and also offer the comfort of human advice. Over time, robo advisors have shifted business models from earning revenue from transactions to AUM-based fee models that will suffer as markets remain soft. Robinhood’s technical problems last week have dented investor confidence at the most ill-opportune time and will shake the trust of customers in all robo advisors.

Payments/Transaction Processing

Payment and transaction processing FinTechs will face a mixed picture. A paralyzed global economy with consumers and corporations curtailing travel and entertainment will have a profound impact on consumption in the short term. This will result in a fall-off in transactions, which are the lifeblood for payment FinTechs. Visa and MasterCard’s warning that sales will fall short of expectations in the current quarter by 2-4% and a sharp contraction in cross-border flows will hit money transfer FinTechs and other payment providers, especially hard. The one bright spot that will continue growing will be the phenomenon of embedding payments in non-financial services that should continue unabated, and may even accelerate driven by the lack of mobility and more online, digital, and mobile transactions. Rosenblatt recently covered the Embedded Finance theme in two Viewpoints available [here](#).

Institutional Capital Markets

Traditional capital markets firms (institutional brokers, exchanges, clearing firms) are benefitting from the current elevated volatility, though runaway volatility for an extended period of time could have the opposite effect of freezing up trading. FinTechs providing trading infrastructure may benefit from this short-term volatility-driven euphoria, but their future depends on how their institutional clients fare as the market downturn continues. Sectors like Alternate Data may suffer as institutional investors become conservative and gravitate towards traditional investment methodology and practices. Capital markets FinTechs focused on better managing risk and lowering costs (outsourced trading, Cloud-based delivery) will gain favor as brokers and asset managers cut costs to maintain margins. RegTech and compliance FinTechs will remain popular as a market dislocation doesn’t impact demand for their services. Investors may double down on these investments boosting their valuations. They may be one of the few bright spots in an otherwise tough FinTech market.

InsurTechs

Usually, massive calamities spell bad news for insurance carriers. But we don't expect large claims from COVID-19 as most insurers most often exclude pandemics or infectious diseases from their coverage. But the virus could boost demand for certain types of insurance by increasing awareness and demand for greater life, health, and business disruption coverage. The P&C sector InsurTechs should not see much difference as an event like COVID-19 really doesn't impact that sector. In other insurance segments that address unconventional risks (cybersecurity, climate change, social disruption), investors have been keenly funding InsurTechs, so the demand for startups in these segments will continue to attract investor interest.



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