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Investment Banking – FinTech Viewpoint

October 2020

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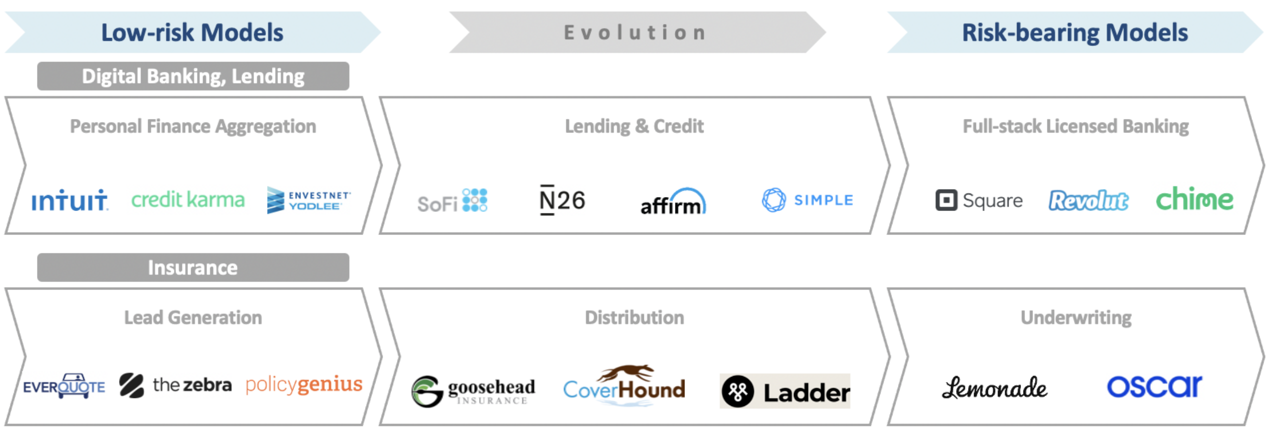
FinTechs Evolve to Full-stack, Risk-Bearing Models

Moving Up The Value Chain from Distribution to Manufacturing

FinTechs Migrate to Risk-bearing Models



Source: Rosenblatt Securities

FinTechs and InsurTechs are evolving from low-risk models like distributors, aggregators, and online marketplaces to risk-bearing models where they leverage their balance sheet, take principal risk and become full-stack service providers. The growing list of FinTechs in consumer banking that applied and has received banking licenses include prominent Challenger Banks Chime, Revolut, Varo, and digital lenders like Lending Club. In insurance, InsurTechs like Lemonade and Oscar started operations as full-stack carriers with underwriting ability, and they are being accorded high valuations by private and public market investors. In payments, the poster child for this trend is Square which has expanded beyond low-risk services (Square POS for merchants and Cash app for consumers) to risk-bearing, principal businesses (Square Capital). Square's banking license was approved in March 2020, and it has an aggressive plan to move further into banking services.

What's driving this trend? FinTechs have begun providing services beyond distribution and up the value chain for three reasons: 1) to control the entire consumer experience front to back, from client acquisition to service and delivery. E.g., in insurance, generating leads, quoting, binding and issuing the policy, and also settling claims, 2) to have the flexibility to offer new products and pivot into new services, rather than being dependent on their financial services partner, 3) it gives them greater legitimacy and engenders trust now they are regulated, and 4) because product distribution has become very competitive while principal, risk-bearing activities have higher barriers to entry.

What's enabling FinTechs to offer these services? Two critical factors: 1) Unlike incumbents, FinTechs move quickly and utilize cutting edge technology and unique business models to provide risk-bearing services but offload that risk through creative partnerships with financial institutions. E.g., InsurTechs like Lemonade are carriers but offload much of that risk at the back end through reinsurance. 2) FinTechs like Square are able to better manage the risk of providing services like lending than traditional financial institutions by leveraging real-time merchant cash flow data that allows them to assess risks better than traditional banks that don't have access to such granular, real-time information.

Four Strategies FinTechs Are Employing to Offer Regulated Services

While the goal of FinTechs is to offer regulated products, they are gaining this ability in different ways:

- The direct approach: The most straightforward way for a FinTech to become a bank is by directly applying for a banking charter. This has been done by Chime, Varo, Revolut, and Square. It is a complex process requiring firms to apply to the Fed and the OCC for a federal charter, or to state banking regulators if they want to operate in select States.
- Partnering with a bank: This has been a popular approach followed by FinTechs for several years, where they partner with a regulated bank and utilize its license to offer regulated services to clients. It essentially means renting a banking license and either paying a flat licensing fee or per-transaction. Stripe partners with Cross River Bank and leverages its license to offer regulated services. Most FinTechs that now have their own banking licenses used to partner with banks but got a icense either because it was more economical or they wanted better control over the entire process. Revolut used to partner with Metropolitan Commercial Bank, Chime with Stride Bank, Remitly with Sunrise Bank, and Varo with The Bancorp Bank.
- Utilizing a BaaS vendor: Another popular approach has been FinTechs using the tech stack and banking licenses provided by banking-as-a-service vendors like Q2 or Synapse. These vendors don't have a banking license themselves but partner with a bank and then offer their FinTech clients the combined package [technology stack + affiliated banking service].
- Acquiring a bank: Finally, FinTechs are becoming banks via acquisitions. The only example of this has been LendingClub buying Boston-based Radius Bank in Feb 2020 for $185 million. While few FinTechs have had the capital to acquire a bank in the past, we may see more such transactions as FinTechs gain in valuation and as smaller banks struggle to stay independent and are willing to be acquired.

Challenger Banks Lead the Way…

FinTechs in consumer banking began in 2010, offering simple financial aggregation services helping consumers combine financial accounts in a single place, so they could better manage finances and achieve long-term goals. Over time, many of these startups began adding new services like cash management, digital wallets, and money transfer, aiming to better monetize customer acquisition costs by enhancing the life-time value of a customer (i.e., drive up their LTV/CAC ratio). But over the past year, a growing number of challenger banks have begun acquiring banking licenses so they can directly offer services that only regulated entities can provide: taking retail deposits, availing of FDIC deposit insurance, or making loans to consumers or SMEs. They are keen to grow new sources of revenue like earning Net Interest Margins on loans, the backbone of bank profitability. The long list of Challenger Banks that have received banking licenses includes Chime, Revolut, Square, and Varo.

…With InsurTechs Following Suit

In each of the four segments of the Insurance industry: Lead Generators, Agency/Brokers, MGAs, and Carriers, there are traditional incumbents, and software-driven, venture-backed InsurTechs. The first wave of InsurTech growth between 2010-2018 saw an overwhelming proportion of new firms in the Lead Generation and Agency/Broker market segments. They generated leads on behalf of insurance brokers and MGAs, without taking on any risk themselves. But in the last few years, more InsurTechs are applying to become licensed insurers so they can write policies on their own paper and take on principal risk. Bestow applied and received its carrier license in April 2020, while Hippo became a carrier with its acquisition of Spinnaker Insurance. Worker's comp insurance broker Pie Insurance set aside $100 million from its recent funding round for acquiring a carrier license.

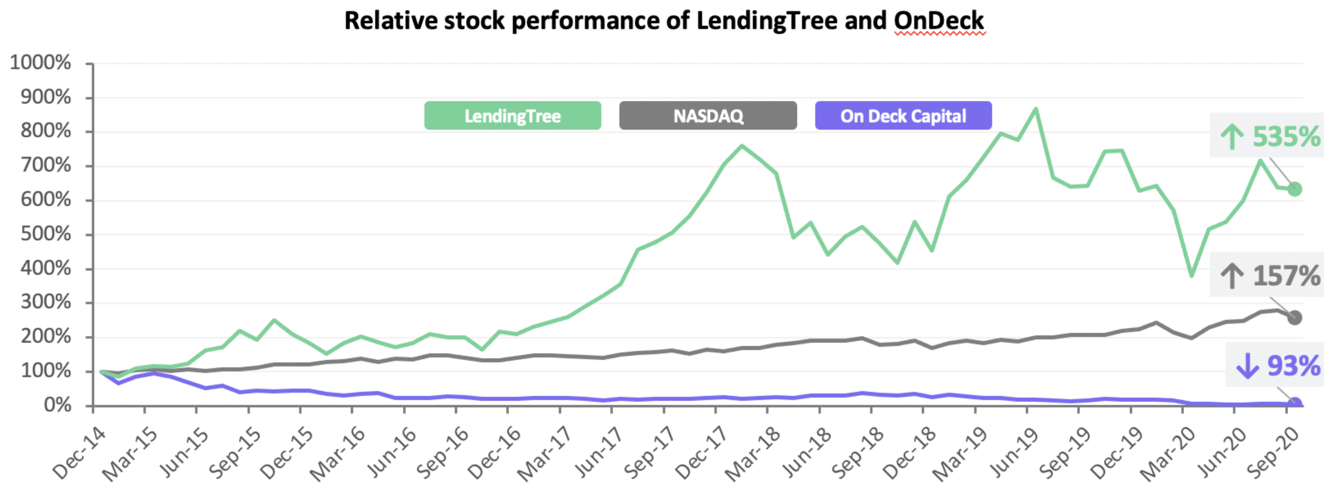
VCs and private investors have become more comfortable funding such riskier models, as these firms have found clever ways to offload a large part of their risk through reinsurance. Public market investors are according higher valuations to risk-bearing firms like Lemonade and Palomar, which trade at 30x and 10.3x forward 2021 TEV/Revenue respectively, compared to lead generators like EverQuote, which trades at 2.4x. This is because lead generators only earn referral fees for each sale, so their revenue can be unpredictable, and their business has low barriers to entry. On the other hand, risk-bearing firms (e.g. Lemonade, Palomar) earn commissions and renewal fees, and have higher barriers to entry. Root Insurance is another risk-bearing InsurTech with a carrier license to underwrite auto policies planning to go public in Q4 2020. Investors seem to be very interested in Root's public listing, undeterred by its risk-bearing business model.

Caveat: Tough Market Cycles Expose the Risk of Principal Business Models

We are not recommending or endorsing FinTechs to adopt risk-bearing models. It has to be a very careful decision recognizing the significant cost, effort, and risks involved in becoming full-stack companies. Obtaining a banking license is complex, expensive, and time-consuming. FinTechs need to consider the significant compliance costs, capital and liquidity requirements, and the hassle of external supervision. Smart FinTech operators recognize these challenges and are treading carefully. As an example, the highly successful money transfer company TransferWise has said it has no plans to become a bank.

Risk bearing models that take on principal risk are much more exposed to tough market cycles that can wipe them out entirely, while agency businesses can still survive through these times. Take the contrasting experience of two digital lenders - LendingTree and OnDeck – with business models on either side of the risk spectrum, who have had vastly different experiences.

LendingTree is America's largest online lending marketplace that offers loan products to both consumers and SMEs on its platform, sourced from a network of banks. It's a classic agent model with low risk where the firm doesn't carry any loans on its balance sheet. OnDeck, on the other hand has always been a digital lender carrying loans on its balance sheet and had a very successful IPO in 2014, pegging its market value at $1.9 billion. This year, the lending business has been caught in the vicious trap of rising defaults and dramatically lower loan demand, hitting principal businesses like OnDeck much harder than low-risk models like LendingTree. OnDeck's value proposition has unraveled, with investors souring on its balance sheet risky model. The firm sold out to Enova for $90 million in June 2020, a 75% contraction in its market value over 24 months. LendingTree has survived, and its stock is up 13% YTD. The chart illustrates the relative stock performance of the two firms over a longer time. Since Dec 2014, LendingTree has appreciated 535%, outperforming Nasdaq by almost 3.5 times, while OnDeck has declined 93%.



Source: Factset, Bloomberg, Rosenblatt Securities

Therefore, high-risk models are much more susceptible to market cycles and can fail catastrophically. The attraction of principal business models (higher barriers to entry, bigger TAM, etc.) must be evaluated carefully against investor skittishness when market conditions worsen, as demonstrated by digital lending this year.

Concluding Thoughts

For the last ten years, FinTechs and InsurTechs have deliberately pursued low-risk business models like the digital distribution of financial services instead of manufacturing financial products that require a banking license and involve taking on balance sheet risk.

But FinTechs across financial sectors from Challenger Banks, Payments to Insurance are evolving towards higher risk models attracted by lucrative streams of revenue, higher barriers to entry, and a desire to monetize customer acquisition costs. More importantly, they are better positioned to enter principal businesses due to unique business models allowing them to offload that risk, and cutting-edge technology to manage that risk much better than incumbent financial institutions.

It is too early to tell if this trend is sustainable, and if investors will continue to value higher risk models longer-term. Acquiring a national banking charter is a long, expensive, and demanding process. And as we have seen with Digital lenders like OnDeck, investors can quickly sour on risk-bearing models when market conditions worsen. As they say, *there ain't no free lunch*.

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