ROSENBLATT SECURITIES

Investment Banking – FinTech Viewpoint

September 2022

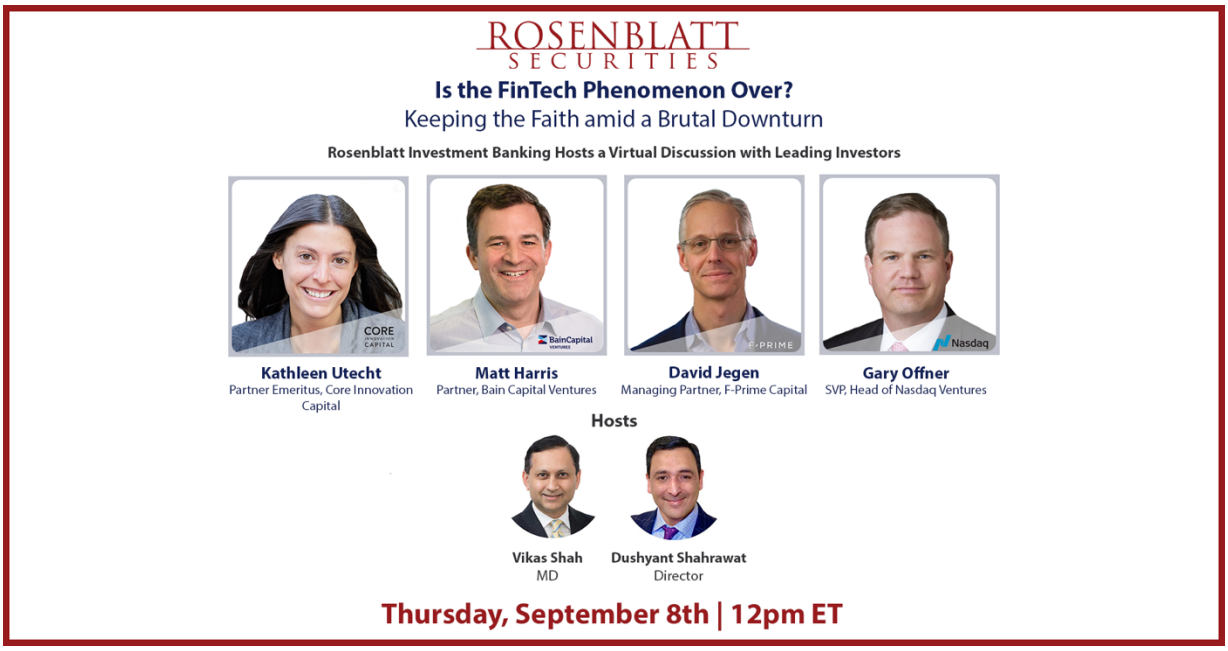
Dushyant "D" Shahrawat
Director, Investment Banking
dshahrawat@rblt.com

Udayveer Singh Chawla
Analyst, Investment Banking
uchawla@rblt.com

Vikas Shah
MD, Investment Banking
vshah@rblt.com

Highlights from Rosenblatt's Webinar with Four Leading FinTech Investors

Keeping the Faith in FinTech Amid a Brutal Downturn

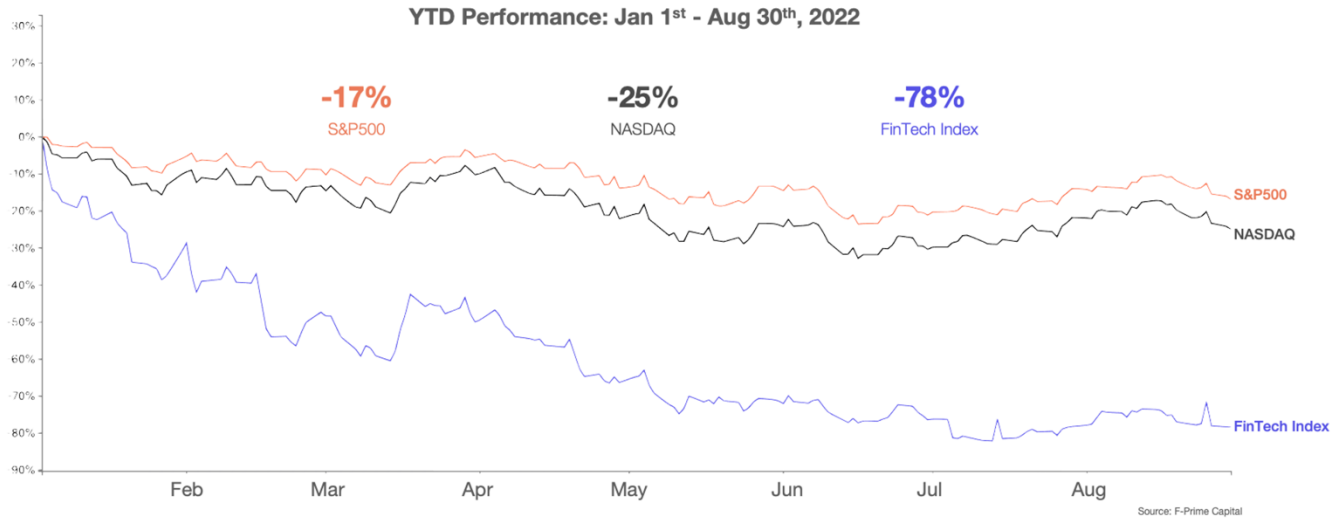


Last week we hosted a timely panel with four leading FinTech investors: Kathleen Utecht – Partner Emeritus of Core Innovation Capital, Matt Harris – Partner at Bain Capital Ventures, David Jegen – Managing Partner at F-Prime Capital, and Gary Offner – Head of Nasdaq Ventures. We discussed critical issues on the minds of FinTech market participants, including the dramatic decline in public FinTech stocks, implications for the private FinTech market and the 322+ FinTech Unicorns, and the state of innovation and competition in this sector. We were especially keen to gauge the panelists' sentiment on how their aggregate 130+ portfolio companies were doing as a proxy for the state of the entire FinTech industry. Two key questions we sought to have the panel answer were: is the FinTech model under threat, and how do we keep the faith amidst this brutal downturn? A recording of the webinar can be watched on-demand here. This viewpoint shares key insights and observations from the investor panel. (Note: speaker quotes are not *ad verbatim*, they have been paraphrased).

1 F-Prime's FinTech Index is an equally-weighted index of 54 US public FinTech companies across Payments, Lending, Capital Markets, Retail Brokerage, etc

Market Performance of Public FinTechs

We began the discussion by looking at the dismal performance of FinTech stocks in 2022, with public FinTechs getting clobbered. As of August 30th, the S&P was down 17% Year to Date, Nasdaq had declined 25%, but the F-Prime FinTech index[1] comprising 54 US public companies had retreated 78%.



This severe underperformance of public FinTechs has shaken investor confidence in this entire sector, and this sentiment is percolating down into the private markets as well.

Matt Harris began the discussion by saying, *"we can acknowledge that year over year FinTech is down massively, and disproportionately to the venture-funded universe… but if we zoom out to five or seven years, it is still meaningfully up".* Indeed, that is true if we look at the F-Prime index performance over 2015-2022. The S&P500 is up 92%, and Nasdaq has risen 149% over that period, but the FinTech index is up 249%. So, we need to take a longer-term perspective on recent FinTech stock returns.

The panel explained that the dramatic decline in FinTech stocks this year is partly a retracement of the massive run-up they underwent during 2020-2021. *"80% of what's happened has been a market valuation correction, which makes sense as firms were trading at 20-30x revenue in 2020-2021 versus the historical mean of 4-6x revenue,"* according to David. Matt explained *"we are now paying the price of our over-exuberance during 2019-2021".* Another factor for the underperformance is that many of these businesses were valued as tech companies and accorded high multiples in the last few years. But as inevitably happens, the market has now revalued them as financial services businesses. David said, *"an early example is Lending Club which got out of the gate several years ago with an outstanding valuation but eventually got repriced… we are seeing that story again with businesses like Upstart".* The last factor the panelists mentioned driving stocks down is just routine cyclicality in the financial services sector, with some sectors like consumer lending particularly exposed to such cyclicality.

The panel also discussed that the entrance of many new investors over 2019 -2022 attracted by outstanding FinTech investment returns early on, drove a massive runup in valuations during this time. Kathleen said, *"the last decade saw new funds come into FinTech, which artificially increased prices because of intense competition*

in doing deals. But many of those opportunistic investors are leaving the market now, driving down prices as a result".

The panel discussed that the wide disparity between private and public FinTech valuations that existed during 2019-2021 would inevitably narrow as investors slow down the total amount of private funding and price rounds at lower multiples than was happening during 2019-2021. Hard evidence of this is Klarna's June capital raise at an 85% lower valuation than its last round, and Stripe voluntarily lowered its valuation by 28% in July from a year ago. That's a decline of 55% from secondary trades done earlier this year at a $165 billion valuation.

Current State of FinTech: Commercial Results Are Holding Up

The commercial results of most public FinTech companies don't reflect clear signs of an economic slowdown or recession yet. The panelists said that most of their portfolio companies – both private and public – were still exhibiting solid YoY growth in most FinTech subsectors. Rosenblatt's analysis of the financials of a sample set of public FinTechs reveals that top line revenue is holding up well, as discussed in our Viewpoint *"Severe Contraction In Public FinTechs Casts A Shadow Over Entire Sector: But Key Growth Drivers Remain Intact and Financial Results Are Holding Up".* The average YoY revenue growth rate for 1H2022 of a sample of public FinTechs which we analyzed (including NeoBanks, Payments, BNPL, and InsurTech) was 41%. While this growth rate is slower than the 87% YoY revenue growth during 2020-2021, does it justify the dramatic 75-80% contraction in these stock prices? The panel seemed to indicate that the 78% decline in the public FinTech index may be an overreaction, especially as business results and growth prospects remain strong, and unless the economy goes into a deep recession, most will continue to deliver growth that significantly exceeds incumbents' growth in their respective sub-sectors. The long-term value proposition of modern FinTech remains compelling: a strong value proposition both in terms of pricing, customer service, and a superior UI/UX, rapid and effective client acquisition through alternate channels, and business models better aligned with customer needs and digital-first product delivery and service. But the panelists acknowledged that the rate of growth in 2022 might be slowing down, and the full impact of a weakening economy may not be reflected in the business performance of their portfolio holdings yet.

The panel also delved into their long-term investing experience and compared this downturn to historical precedents. While the pace and number of funding transactions have slowed this year, deals are still getting done in sharp contrast to Spring 2000, when funding grinding to a halt across both early, mid, and late-stage rounds. Gary said, *"the casualty count was much higher back then with many false pretenders meeting their demise."* Another sharp difference is that, unlike that time, a record amount of dry powder is sitting on the sidelines with the clock ticking for that capital to be deployed.

Adding a note of caution to founders, the panel said that a lot of FinTech investors have hit the pause button on new deals and are reassessing pricing, so founders shouldn't expect deals to be done quickly or on favorable terms. Gary mentioned that *"the pendulum had decidedly swung back in favor of investors with protections like liquidity preferences, equity rights, and other restrictions back in vogue on term sheets."* There are classic signs of a slowdown in the private market with voluntary write-downs by FinTechs, investors like Fidelity marking down prominent holdings, stricter conditions for raising capital, and more down rounds than the FinTech sector has experienced for many years.

Meanwhile, investors are counseling their portfolio companies to reduce burn rates, be more transparent about their unit economics, and fast-track profitability. That is a dramatic about-turn from the sentiment over 2019-2021, when top-line growth was the key metric being measured, and the valuation in subsequent rounds was based on such growth. In contrast, David said, *"private investors are now more closely following the good old Rule of 40"* which says that startups whose combination of free cash flow and revenue growth adds up to 40% made good investments and tend to perform much better.

The underlying sentiment we took away from this part of the discussion was that these investors felt that the long-term value proposition of the modern FinTech model still remains intact: a superior UI/UX, rapid and cost-effective client acquisition through alternate channels, business models that are better aligned with customer interests than incumbents, and a digital-first product delivery and service model. So as long as founders maintain their long-term course of developing innovative financial products, maintaining a low CAC/LTV ratio, and driving towards profitability, both public market investors and the private markets should recover after we get over this rough economic match.

Insights About Business Models and Individual Sectors

Our panel of investors shared key observations about individual FinTech sectors shedding light on business results, current and future performance, and relative prospects for growth.

There are stark differences between how B2B and B2C models are faring both in the public and private markets. B2B FinTechs with recurring revenue and high gross margin business models have been caught in the downdraft hitting all FinTechs, but the panel believes their decline has stopped, and they should begin to recover going into 2023. In contrast, for B2C companies, it's a brave new world with hundreds of unregulated and undifferentiated consumer financial/investment propositions (e.g., in very little differentiation offered by Neo-Banks and Robo-Advisors) that will likely struggle in a weakening economic environment. The dispersion in performance among that group will be quite dramatic, with *"real winners having staying power but a lot of companies simply going away,"* according to Matt.

For FinTechs in highly cyclical sectors like consumer lending (especially mortgages) and retail brokerage, the going will be tough, as reflected in weak business performance. Businesses like Coinbase and Robinhood are experiencing large revenue declines, and investors are rerating them accordingly. Of course, these sectors are also very crypto and retail-driven and both these platforms saw massive spikes in volumes during the COVID-era due to significant government assistance and reduced expenses. This has reversed since the opening up of the economy and in the current economic slump. A 50-70% collapse in Crypto prices hasn't helped them either, driving down their financial results.

We then discussed consumer lending with Matt eloquently, saying *"the mortgage business is wildly, savagely, viciously, brutally cyclical, and it's not going to smooth out anytime soon. It's always going to be that way."* So a tougher economic environment will hurt lending companies whose models made sense in normal rate environments but will struggle as rates start rising. Meanwhile, the BNPL sector which performed outstandingly well in 2021 is now bearing the consequences of a weakening economy much more seriously than other FinTech segments, with a gradual weakening of conditions expected to drive up consumer delinquencies and defaults. The panel acknowledged the steep drop in public BNPL stocks like Affirm and write-downs of private company valuations like Klarna as evidence of this.

For the mortgage business, Matt said, *"the mortgage business is wildly, savagely, viciously, brutally cyclical, and it's not going to smooth out anytime soon, it's always going to be that way."* So, a more demanding economic environment will hurt Lending companies whose models made sense in normal rate environments but will struggle in this high-rate environment.

In the capital-intensive PropTech sector, whether lending or equity models, the cap rates (or yields) have always been low in absolute terms, which is why it's always been a high-risk/return asset class. So for residential PropTech capital-intensive models that borrow money to exist, if rates go up and they can't pass it on, it may even become an extinction event for them.

The next sector discussed was WealthTech, with David saying that *"the Robo advisory space is an example of incumbents reacting quickly and effectively to competition from FinTechs partly through acquisitions",* like Blackrock acquiring FutureAdvisor, Vanguard buying JustInvest, Northwestern Mutual tucking in LearnVest, and Empower picking up Personal Capital. Incumbents like Fidelity Investments, Schwab, and Morgan Stanley/ETrade have significantly improved their UI/UX, matched low/no fees, and new services (like fractional shares) that were pioneered by FinTechs like Robinhood. This has significantly shrunk demand and the addressable market for WealthTech and Robo advisory firms, which partly explains why there have been multi-million-dollar acquisitions but not billion-dollar deals. The recent withdrawal of UBS' offer to acquire Wealthfront for $1.4Billion in cash confirms that incumbents are willing to go it alone and stave off competition from WealthTechs and Robo advisors. However, the one area that is thriving in the asset management space is alternative investment platforms, such as iCapital Network and Moonfare, which offer access to non-traditional assets classes to retail investors and RIAs.

Consumer InsurTechs (especially the brokerage-driven models in auto/home/renters insurance market) have run out of their ability to differentiate, and without access to cheap capital, which gave them a structural pricing advantage, these firms will have to reinvent themselves meaningfully to remain a durable, long-term model. InsurTechs in niche specialties and areas may succeed but won't be effective in competing against compelling competitors in mainstream insurance business lines.

Gary led the discussion about Blockchain mentioning Nasdaq Ventures' investment in Fnality, a consortium to launch Stablecoins on central bank deposits, which has received regulatory approval from the Bank of England – the first central bank-regulated DLT-based payment system. He described the significant opportunity of using Blockchain and DLT for clearing models and credit intermediation in capital markets saying, *"that is the most interesting area in this sector."* The panel noted that using Blockchain to rewire the plumbing of key financial sectors like Capital Markets was in its early stages, and there was a tremendous growth opportunity ahead for this. Two examples we can think of are: Paxos using the Blockchain to offer an alternative to the current end-of-day DTCC-driven equity settlement process and FTX's proposal to the CFTC to clear/settle Derivatives trades without having to become a Futures Commissions Merchant (FCM). But Gary cautioned that *"there are significant vested interests in maintaining the status quo, especially in areas like Capital Markets, so progress may be slow. But it will eventually happen."*

Risks and Opportunities Looking Ahead

The final topic of discussion was the risks and opportunities in the FinTech space over the next 12 months. The biggest uncertainty on everyone's mind was macro conditions and a general economic slowdown that would

disproportionately hurt FinTechs compared to incumbents and weaken their competitive position. Matt mentioned *"stagflation like the 1970s and geopolitical concerns"* as his biggest concern.

Another risk echoed was the impact of a long, protracted 10-15% decline in corporate tech spending in this economic downturn. Such a decline in IT budgets would hurt all FinTechs that directly or indirectly sell to the technology divisions of financial institutions dragging down demand for their products and services. A lot of FinTechs have grown robustly in past years by selling services and infrastructure to startups across industries, and more specifically, to help early-stage FinTechs get off the ground. With an impending decline in new startup activity and a slowdown in early-stage funding, this could be a significant drag on the growth of FinTechs that sell to startups or that power other early-stage FinTechs. Serving smaller companies was a big tailwind in the last few years but may end up being a headwind as the economic situation worsens.

Regulation was another big uncertainty mentioned by the investors. A prime example is if regulators come after BNPL providers for not adequately determining customer suitability and overloading them with loans in past years. Regulators may respond by imposing fines on BNPL providers to partly compensate for customer losses. Larger players like Apple may be able to absorb such fines, but smaller, independent BNPL players may capitulate and be forced to close shop. The SEC is also mounting pressure on the Crypto space by investigating prominent firms like Coinbase for allegedly trading unregistered securities. This could have a chilling effect on all crypto exchanges and token projects. The last regulatory uncertainty mentioned by the panel was how regulators might decide to supervise and regulate Banking-as-a-Service (BaaS) providers. If they deem such firms to be systemically important and be treated as financial infrastructure providers, it would mean significantly higher costs and regulatory burdens, which these firms are ill-equipped to handle. Kathleen cautioned that *"FinTechs had grown in past years because of a light-touch regulatory environment, but if regulations encircle it, then growth may slow down on the front-end."*

Turning to the bright side, the panel identified four big opportunities for FinTech going forward:

- A huge long-term opportunity is *"embedding finance"* into vertical industry solutions. Transforming the four basic financial activities (payments, lending/borrowing, investing, and insuring) from distinct, separate services manufactured by specialized, regulated financial entities and distributed by a narrow set of providers to being natively integrated into vertical software solutions. Matt said, *"this trend will keep us busy FinTech investors like me busy for a long time to come."* A recent Bain Capital Venture report estimates that 5% of financial transactions in 2021, worth $2.6Trillion, came from financial services embedded in e-commerce and other software platforms, and this would rise to $7Trillion by 2026, a CAGR of 22%.
- The panel agreed with the moderator's hypothesis that over time much of the world's assets would be tokenized and brought on-chain creating big opportunities for all FinTech. Gary said, *"I think digital assets and tokenized securities are coming but we need clarity on what constitutes a security and what disclosure, listing, and trading requirements are for them."* There is a tremendous opportunity to fund the infrastructure required to provide on-chain assets with a lot of *"alpha generation that can be captured by investing in technology to modernize Capital Markets."*
- David said there would be continued *"expansion of the universe of investment assets provided to retail investors including alternatives like Crypto, art and collectibles, direct access to real estate and private*

credit." A lot of FinTechs have been focused on this for the last few years, and that trend may accelerate with more investor interest and further regulatory relaxation to offer such assets over time.

- On the opportunity for FinTechs to make a meaningful difference in ESG, financial inclusion, and climate change, Kathleen said, *"I would give our industry a B for what it has achieved, but there is tremendous opportunity to do a whole lot more."* She mentioned that because Neobanks like *"Dave, Chime, and Brigit exist, the incumbent banks have been pushed to eliminate overdraft fees,"* so these FinTechs are catalysts for positive change.

Closing Thoughts

We hosted this webinar with the backdrop of a dramatic downturn that public FinTech stocks have experienced YTD and deep concern among investors that the modern FinTech experiment may be ending. Our panel of esteemed investors - with over 100 years of combined experience in funding financial technology - acknowledged these concerns but provided optimism and hope for our sector's future. As evidence, they pointed to the continued robust financial and operating performance of most of their FinTech portfolio companies despite an economic slowdown. They agreed that the tide that lifted all FinTech boats during 2019-2021 was receding, and this downturn would create winners and losers, but this catharsis would strengthen this sector, preparing it for the next stage of long-term growth.

ROSENBLATT
SECURITIES