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Dushyant “D” Shahrawat
Director, Investment Banking
dshahrawat@rbld.com

Arjun S Lal
Intern, Investment Banking
alal@rbld.com

Vikas Shah
MD, Investment Banking
vshah@rbld.com

Public Market FinTech Performance Raises an Alarm: Is the FinTech Story Still Intact?

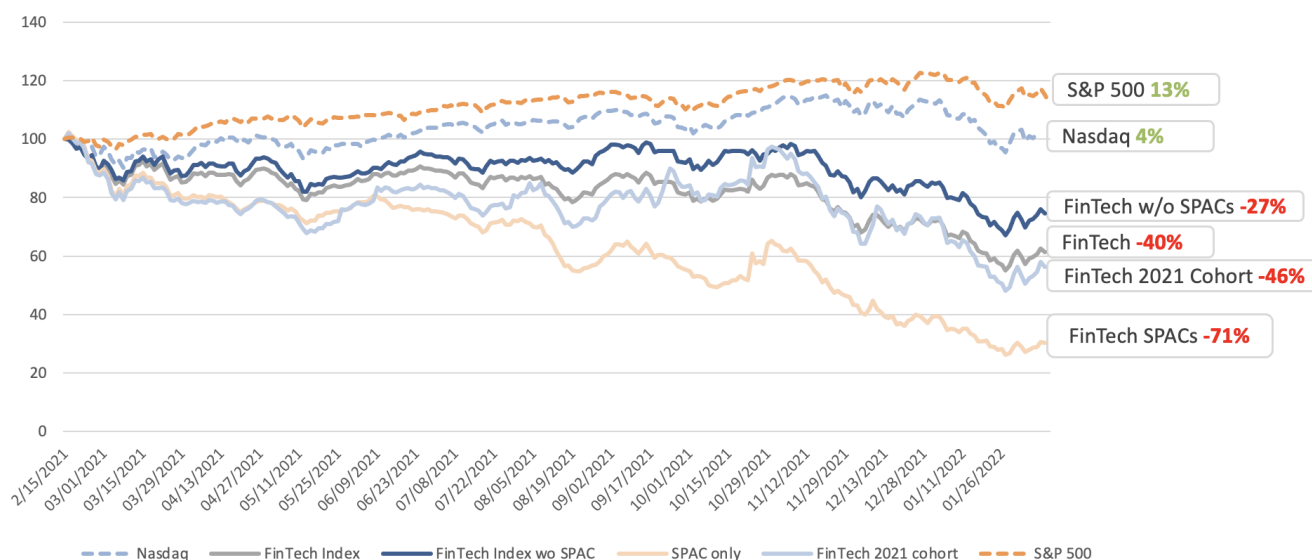
Short-term Hiccups, But Longer-term Value Proposition Remains Intact

The weak performance of public market FinTechs is making some people wonder if the FinTech story is still intact and what's in store for this sector in the short term. This Viewpoint examines current perceptions about private and public market FinTechs and shares Rosenblatt investment banking team's thoughts on this issue.

2021 was a banner year for FinTech with record private-market funding, M&A transactions, and many IPOs and SPACs completed. An estimated \$135B in private capital was invested in private FinTechs, 206% higher than in 2020. YoY median step-up in valuation rose from 1.6x to 2.3x pushing the number of Unicorns worldwide to 208, over 60% of which reached that level in 2021. It was also a massive year for US IPOs, with 388 companies going public including, 24 FinTechs, through the traditional IPO and SPAC route.

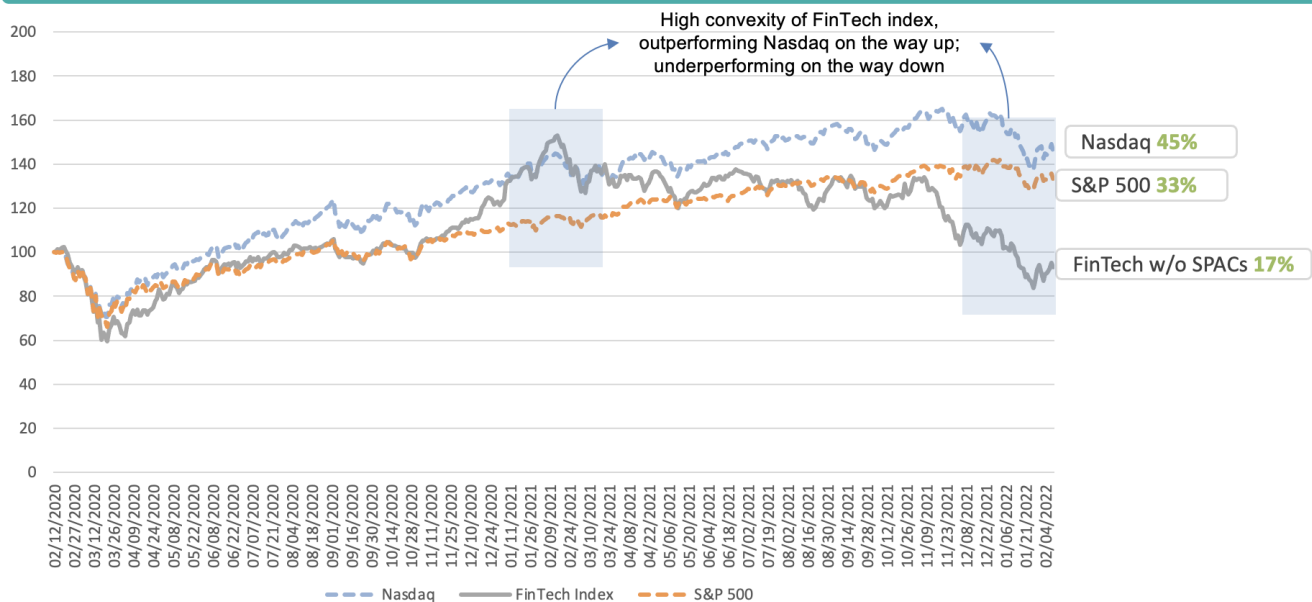
But the investor mood around public market FinTechs has soured since November 2021, with these stocks getting caught in the violent downward revaluation of all growth stocks in the last 90 days. As illustrated in the first chart below, Rosenblatt's FinTech index comprising 55 public firms is down 40% YoY through Feb 9, 2022, compared to Nasdaq, which is up 4%, and S&P being up 13%. Furthermore, the cohort of FinTechs that went public in 2021 is down 46%, while FinTech SPACs are down a whopping 71%. This is not altogether surprising since the public market FinTech index acts like a high beta stock with high convexity, which means it outperforms Nasdaq on the way up and underperforms it on the way down. This is evident from the second chart, which shows how the FinTech index beat Nasdaq's performance during Feb 2021 but underperformed in Feb 2020 and more recently in Jan-Feb 2022.

Last 12 Months FinTech Index Performance Relative To Broad Market (Feb 15, 2021 – Feb 13, 2022)



FinTech Index Composition – 55 companies in InsurTech, Capital Markets, Payments, Online Lending, Personal Finance. Includes companies that went public via SPAC
FinTech w/o SPAC Index Composition – 42 companies in InsurTech, Capital Markets, Payments, Online Lending, Personal Finance. Excludes companies that went public via SPAC
FinTech 2021 cohort Index Composition – 23 companies in InsurTech, Capital Markets, Payments, Online Lending, Personal Finance. Includes companies that went public via SPAC. Assumes investment in SPAC in 2020 before acquisition of target in 2021
FinTech SPAC Index Composition – 13 companies in InsurTech, Capital Markets, Payments, Online Lending, Personal Finance.
 Data updated as of February 13, 2022. No. of companies are as of February 13, 2022. All indexes are equal weighted indexes

Last Two Years FinTech Index Performance Relative To Broad Market (Feb 12, 2020 – Feb 13, 2022)



FinTech Index Composition – 55 companies in InsurTech, Capital Markets, Payments, Online Lending, Personal Finance. Includes companies that went public via SPAC
FinTech w/o SPAC Index Composition – 42 companies in InsurTech, Capital Markets, Payments, Online Lending, Personal Finance. Excludes companies that went public via SPAC
 Data updated as of February 13, 2022. No. of companies are as of February 13, 2022. All indexes are equal weighted indexes

This severe underperformance of public FinTechs in the last few months has raised a number of questions: have the private markets been according FinTechs much higher valuations compared to public market investors? Will this severe contraction in public FinTech stock valuations get reflected in the private market? How will the tough reception given to new IPOs impact prospects for the 208 Unicorns on the IPO on-ramp? And perhaps the biggest question of them all – is the FinTech story still intact?

A Brief Look Back at FinTech's Genesis

Let's briefly review when/why the modern FinTech revolution began. While Paypal led the charge from analog finance to digital finance in 2001, the more sophisticated, software-driven FinTech movement started after the Global Financial Crisis (circa 2009), taking advantage of the weakness of incumbent financial institutions:

- After the GFC, traditional financial institutions exited parts of the market like low-income retail banking and SME lending as firms tried to shore up balance sheets and improve their financial performance by exiting weak business lines. This left many customers and communities behind with financial needs going unmet
- High fees (e.g., overdraft), conflicts of interest, and the questionable conduct of large financial institutions during and after the 2008 crisis caused a loss of consumer trust and confidence, creating an opportunity for new FinTech brands that promised to serve customers by deftly using mobile technology, slick UX/UI, AI/ML, etc.

So in the tough aftermath of the GFC, a number of prominent FinTechs began (Square – 2009, Stripe – 2010, SoFi – 2011, Coinbase – 2012) led by a new crop of technologists looking to redefine finance with software and backed by Silicon Valley investors that believed in the vision of revolutionizing finance. These FinTechs were built from the ground up with modern technology, deployed over the Internet and mobile, significantly better UI/UX than traditional providers. FinTechs also leveraged Social Media channels very effectively to acquire new customers, especially Millennials and Gen Y/Z, in sharp contrast to traditional companies, which used expensive distribution channels to focus on 25+ year olds. FinTechs understood the power of mobile-first offerings, which became the cornerstone of their go-to-market strategy.

But the first wave of FinTechs offered monoline products, serving narrow customer needs instead of a broad set of services. By simplifying and gamifying services, distributing them over the Internet/mobile channels, with significantly better interfaces, and by removing a few critical impediments, adoption grew among traditional customers, and there was greater participation from entirely new segments of customers. For example, instead of a conventional brokerage account from Schwab offering whole shares, fractional shares became available over Robinhood, which attracted millions of new customers now able to invest for the first time with small balances of just \$100. On the service side, instead of a consumer bank charging customers overdraft fees, FinTechs like Chime began responding to customer needs by offering payday loans to low-income customers. That marked a profound change for the staid financial industry, and consumers responded by signing up in droves to these new-age companies. Payment companies like Paypal (through its acquisition of the parent of Venmo) and Square (through the consumer-facing app, CashApp) amassed tens of millions of customers in record time to surpass large incumbents like JPMorganChase.

In their second stage of growth circa 2017, prominent FinTechs began expanding beyond their original product, going multiline and rebundling more products. For example, SoFi expanded from student loans to mortgages and onto securities brokerage. The drivers were growing constraints on organic growth in their monoline product, a financial need to monetize customer acquisition costs (CAC), and customer demand to rationalize the number of provider relationships. At the same time, there was much greater technology enabling FinTechs to rebundle: banking-as-a-service platforms that enabled rebundling, a wide availability of APIs that made service integration easier, and enabling technologies like Cloud, AI/ML and advanced analytics.

But the aggregation of multiple services and offering them under a single brand or via an integrated product set was not a new concept in finance. Incumbents had been doing that for years. What was different with this modern rebundling by FinTechs was how they provided bespoke services tailored to a customer's lifestyle and better attuned to her needs instead of being motivated solely by the bank's financial interests. Rebundling by

FinTechs was also rapid, dynamic, and personalized, with providers able to add products via partnerships or second generation APIs to 'serve up' solutions (e.g., Stripe for Payment, Plaid for Data, Xignite for Market Data). To sum up, the FinTechs addressed the ignored or underserved segments of the markets (popularly coined as "financial inclusion") with high-quality value propositions by harnessing the power of modern technologies in designing and delivering products and servicing the customers, either organically or by partnering with third-party providers. At this early stage of growth, the FinTech focus was on capturing market share and generating topline growth rather than ensuring profitability.

All this, combined with ample liquidity and rising markets, created a perfect environment for a flood of FinTech Unicorns to go public during 2020/2021. 54 FinTechs went public during 2020-2021 with some of the biggest names being Coinbase, Robinhood, and SoFi. Traditional financial institutions were surprised at the success of FinTechs and envious of their tremendous stock performance coming out of the IPO gates. But this all reversed sharply starting in late November 2021, with public market FinTechs declining much more than tech/growth stocks and the FinTech index under-performing Nasdaq by 44%, as investors demanded the fiscal discipline typically expected from more established incumbents. This leaves customers, investors, and other market participants worriedly thinking: *is the FinTech story still intact? Where do we go from here?*

So is the FinTech Story Still Intact?

We would like to believe so if one defines the story to be the high-quality customer value propositions that FinTechs continue to deliver vis-à-vis incumbents. Our analysis indicates that the price performance of public market FinTechs has more to do with investors souring over growth and tech stocks and less a reflection about the long-term value proposition of FinTechs. It has more to do with *valuations*, and less to do with the intrinsic *value* of FinTechs. The current investor trepidation has more to do with broad macro concerns about expected rate increases due to the Fed tightening and the risk of an economic hard landing. While the FinTechs are delivering strongly on most operating metrics, the broader reversal of investor interest away from growth/tech stocks is what is impacting public FinTechs.

The question is: if we consider the drivers that caused FinTechs to emerge in the first place, are those drivers still intact? We believe they are! All the reasons why this modern FinTech revolution began in 2009 remain intact. These firms still represent a bright hope for financial inclusion, in serving the unbanked, amassing millions of customers to whom they can provide a wide array of innovative products, organically and through third-party partnerships, with a superior UI/UX, lower fees and less friction, more transparency, and greater responsiveness to customer needs. FinTechs have skillfully deployed technologies like AI/ML and blockchain to glean insights from the vast amounts of data they are collecting, which are then used to offer on-demand and just-in-time products and services to customers, further increasing their value proposition. FinTechs have also used social media channels more deftly than incumbents to gain traction with Millennials and GenZers, where ultimately, the growth is. Unlike 2009-2010 when FinTechs were new and untested, it's more than a promise today, FinTechs have a 10-year track record of serving customers very well. Yes, incumbents may have woken up to the FinTech challenge, with consumer banks like Capital One eliminating overdraft fees which irked consumers, or retail brokers like Schwab and Fidelity eliminating commissions, but FinTechs still have the lead. The challenges of high costs, friction, slow innovation, and a lack of transparency still plague most incumbents.

The recent financial performance of public FinTechs is the best evidence that the model remains intact. Public FinTechs are continuing to drive top-line growth. SoFi grew its customer base 96% YoY, with an expected 49% growth in Net Revenue for 2021. Affirm just posted a 77+% YoY increase in revenue, with a 150% rise in customer count and a 2030% growth in the number of active merchants on its BNPL platform. In its most recent

quarter— Q3 2021, Coinbase's Revenue grew 4x while Net Income climbed 5x. Those are impressive financials for any public company. This financial performance is not reflected in the stock price of the 55 public FinTechs that we track, as they are caught in the same downdraft affecting all tech and growth stocks with investors souring on them.

Observations and Things to Watch Out For in 2022

While the software-led, modern FinTech model will prevail over the long term, we recognize the changes that this sector is undergoing, led by the under-performance of public FinTechs. Here are things to watch this year in the FinTech market:

- FinTech CEOs forced to grow-up fast: Private FinTech CEOs have operated in a relatively benign time during the last few years, with investors largely encouraging them to scale up, even if it meant taking risk and making mistakes along the way. But for the FinTechs that went public recently, it has been a tough growing-up lesson. As one CEO of a FinTech that went public last year said "going public forced us to grow up fast. It was like asking a 10-year-old to have the maturity of an adult!"
- Valuations of private FinTechs likely to get impacted: Changes in the valuation of public companies in a particular industry sector tend to get reflected in private market valuations with a 6-9 month lag. So we may experience some softness in the price and terms of private FinTechs this year. The rich, tech-driven valuations accorded to FinTechs as if they were high-tech, SaaS companies may get rationalized. There is anecdotal evidence of this rationalization already happening, with 10-20% declines in the valuation of private FinTech shares being traded on secondary platforms like EquityZen and Forge Global
- Rising rates will hurt certain sectors: As rates rise and the credit cycle turns, some FinTech sectors are bound to get hurt. Over 80% of existing FinTechs haven't experienced a rising rate environment and may be caught flat-footed as liquidity tightens, capital is constrained, and customer spending declines. Consider the BNPL sector, which experienced blistering growth in 2020-2021. Firms like Affirm, Klarna, and Sezzle will be exposed to rising rates, and their margins may get crimped because they fund free customer installments with merchant credit and internal funding. Intense competition among BNPL players will limit their ability to pass on interest rate increases to customers, and with credit losses mounting, they may not have the cushion to shield them
- Marginal players will get weeded out: Looking back a few years out, early 2022 may well mark an inflection point when marginal FinTech players started getting weeded out, and there was a culling of the FinTech herd. This would be a departure from the last few years when there were a lot of new startups emerging in every FinTech vertical, with even marginal players with less robust business models getting funded easily
- VCs less willing to fund high CAC strategy: The period when VCs patiently allowed portfolio companies to use significant amounts of funding to acquire customers at a high CAC may be ending. Investors are turning up the heat on FinTech management, expecting higher growth rates with a lower CAC and guiding portfolio companies to drive their LTV/CAC ratio well above 3.
- Reducing excessive reliance on Social Media for customer acquisition: FinTechs will have to reduce their excessive reliance on Social media channels to acquire customers, which they have been doing for several years. Apple's decision in Nov 2021 (with the iOS 14.5 release) to curtail direct-to-customer advertisers like Facebook in selling consumer data to firms (including FinTechs) was a gamechanger. FinTechs must develop alternative ways to acquire customers, and smart FinTechs are responding by developing influencer-driven models or acquiring media companies and channels in place of Social media-driven customer acquisition.

Conclusion: Long-term Story Remains Intact Despite Public FinTechs Doing Badly on Wall Street

What a rude awakening for the FinTech sector in the last 60 days! Even bellwethers like Paypal and Square have contracted 40% and 35%, respectively, compared to Nasdaq being down 12% over the last two months. The 23 FinTechs that went public in 2021 via IPOs/SPACs are down 46%, while the 13 FinTech SPACs (from 2021) are down 71%. That's enough to question any optimist's faith in this sector. Yet, we believe that the longer-term value proposition and growth rationale for well-run FinTechs is secure and robust. The recent performance of public FinTechs is driven by a broader reversal in investor appetite for growth and tech stocks, instead of a dislike for this sector in particular. But since FinTech stocks have high convexity and act like high beta stocks, they have severely underperformed the Nasdaq recently. The opposite was true when the Nasdaq was on its way up with FinTechs handsomely outperforming tech and growth stocks. Despite the dismal stock performance of FinTechs on Wall Street recently, the core value proposition that allowed modern-era FinTechs to get off the ground post-2009 remains intact, and there will be better days ahead. We recommend keeping the faith.



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