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Disruptions Driving FinTech Investing


VISA
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Introduction

The global FinTech marketplace is experiencing significant changes as new and disruptive technology is having a major impact on products, services and business models.

There is a wave of capital flowing into startups looking to disintermediate the major financial institutions. All of a sudden, there are significant investment opportunities in a market ready to embrace new and innovative technologies.

This white paper will explore why the FinTech market is attracting so much attention, it will highlight the two distinct segments of the FinTech landscape, and look at some of the key factors driving innovation and investments. It will also provide thoughts about how Information Venture Partners sees the FinTech landscape and where its investment efforts are focused.

NOTE: The definition of FinTech has been rapidly evolving. We look at FinTech as financial and information technology that includes front office/consumer-facing services and software, and back and middle office innovation. This market includes banks, insurance companies, investment and asset managers, capital market firms, payment companies, loyalty programs, and analytics of data collected by any of the aforementioned.

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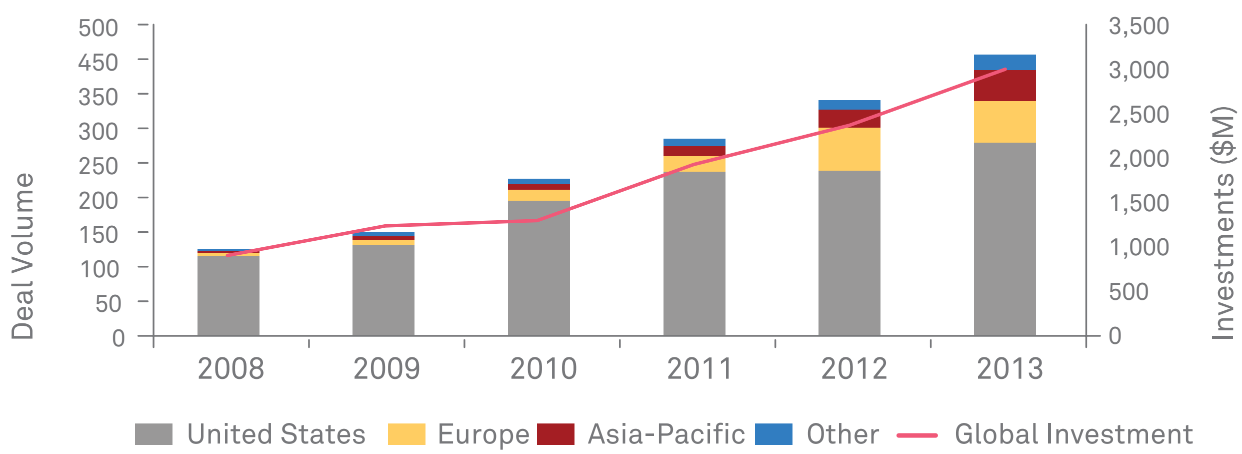
FinTech investment on the rise

The Dawn of FinTech 2.0?

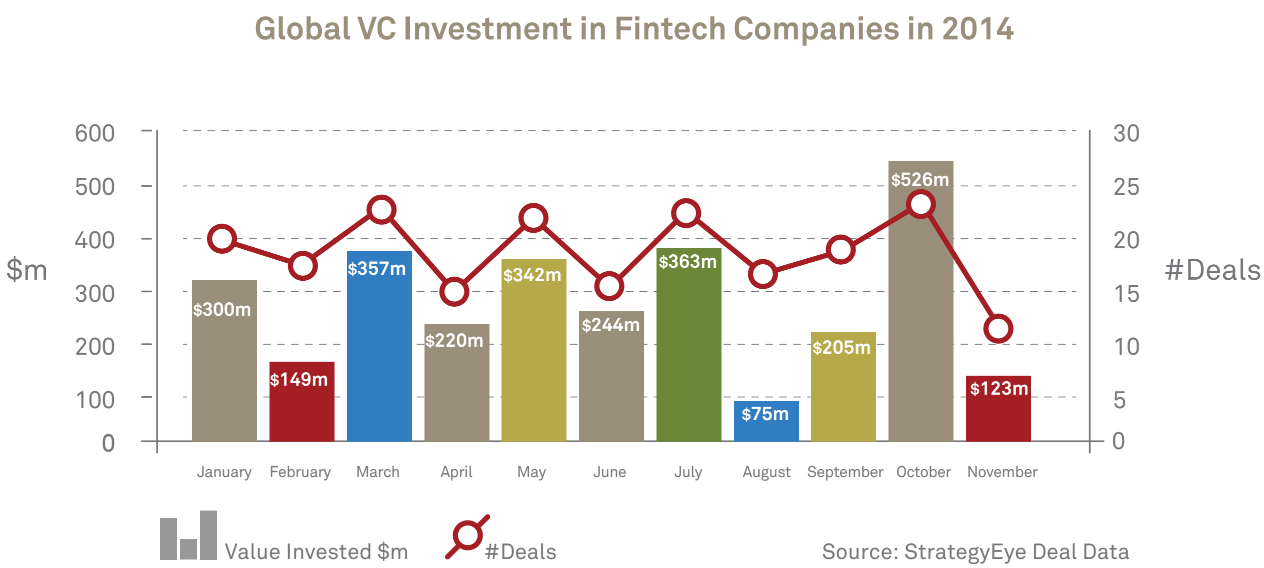
While the spotlight may be shining on the FinTech market, it is not a new phenomenon. Over the past five years, investment in FinTech start-ups has been steadily growing. According to CB Insights, in 2013, there was more than $3 billion of global financing activity. This represents a nearly 3-fold increase since 2008 in dollars invested and companies financed. Investments in North American continue to lead by a significant margin but the rest of the world has experienced faster growth, especially in 2012/2013. Canadian investment in FinTech is not tracked, although, anecdotally, it is not proportional to the presence that our financial institutions have globally.

Global Fintech Financing Activity



Source: Accenture and CB insights

Here is a more granular look at the FinTech investment landscape, showing the number of deals and their value in 2014.



Setting the Stage for $1-billion Startups

"There is a confluence of modern technologies, business imperatives and non-traditional competitive pressures in financial services that are creating a perfect environment to build the next billion dollar venture backed company," says David Unsworth, co-Founder and General Partner with Information Venture Partners. "Cloud infrastructure, new analytical techniques, and an expectant client base - both consumer and business - will fuel a massive revolution in the business in the next five years"

The three factors driving investment activity

Renewed interest in building market share and launching new products

1 From 2008 to 2011, there was an underinvestment in FinTech. In the wake of the 2008/2009 global economic crises, precipitated by the financial services industry, financial institutions focused on cost cutting to maintain profit margins. There was less attention on investing in, or embracing of new and innovative technologies.

As economic conditions have improved, however, there has been a renewed interest in building market share and launching new products. A key part of this strategy is innovation, specifically how to leverage technology to modernize how business is conducted, which new products to launch and how to optimize client relationships.

Celent, a research and consulting firm, says financial institutions that embrace innovation as a corporate strength can establish a branding advantage.

2 There are a growing number of disruptive startups aggressively pursuing new opportunities, particularly in the B2C segment. As consumers become more digitally engaged and mobile devices ubiquitous, there is demand for better and easier access to financial services. Startups such as Square and Stripe are attacking "low hanging fruit" through technologies that leverage low cost, cloud computing, powerful mobile devices, and easily available interfaces to bypass channels owned or controlled by incumbent financial institutions. As these startups attract more users and media coverage, investors are increasingly excited about this next generation of new and disruptive challengers.

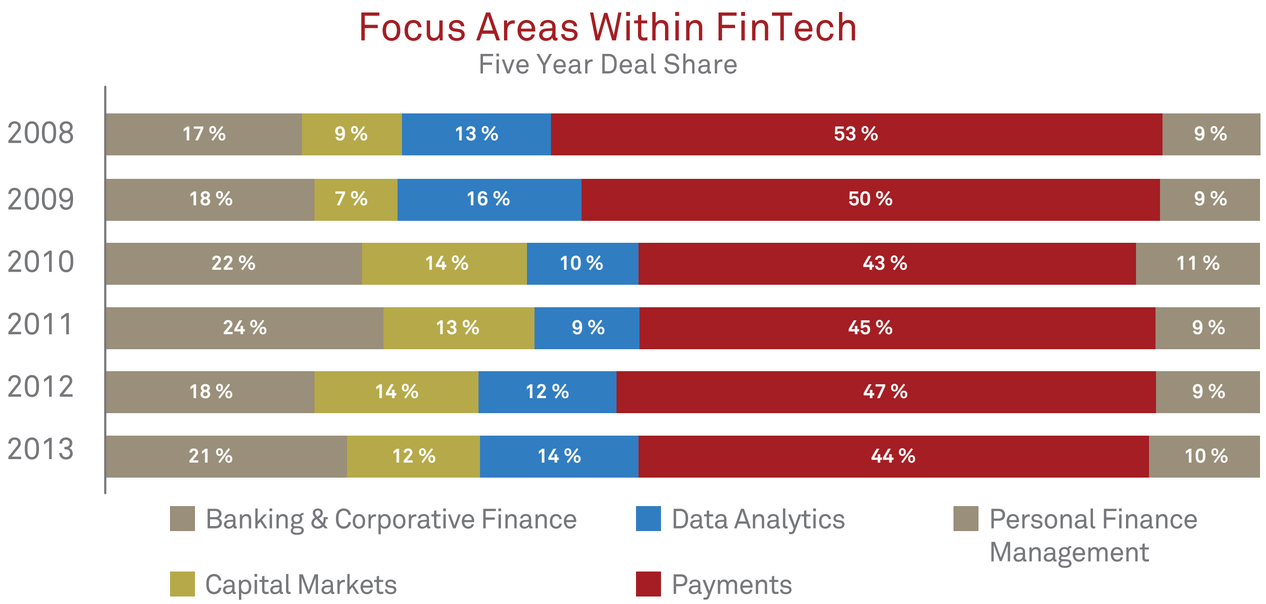
"We have a chance to rebuild the system. Financial transactions are just numbers; it's just information. You shouldn't need 100,000 people and prime Manhattan real estate and giant data centers full of mainframe computers from the 1970s to give you the ability to do an online payment."

- Marc Andreessen

3 Tech-savvy millennials do not trust banks. According to the Millennial Disruption Index, 71% of millennials would "rather go to the dentist than listen to what banks are saying", while 53% do not think their banks offer anything different than other banks. Translation: if banks want to gain or retain customers, they have no choice but to embrace innovative technology. We believe that banks are at risk of becoming irrelevant. "Banking is at the highest rate of disruption", the Millennial Disruption Index concludes. "The change will be seismic".

One of the biggest drivers for FinTech is the size of the market. Gartner estimates global enterprise IT spending for the banking and securities market was $485 billion in 2014. Although barriers to entry may be high, the financial services market is too big to keep disruptive players from entering the fray. The risk for financial institutions is that if they do not have the right technology, it will become more difficult to compete. Adopting innovative technology will not only let financial institutions battle disruptive players, but also provide new opportunities to drive revenue and profit, and expand product portfolios.

Payments has taken over 40% of FinTech deals in each of the past 5 years



Note: 2013 figures through June 30, 2013

The two worlds of the FinTech market

At Information Venture Partners, we believe it is important to divide the FinTech market into two distinct worlds: front office and back office.

The front office

The front office or consumer market has attracted a lot of the spotlight. It is a large, sexy market with products that people use on a daily basis. Startups such as Square ($200 million), Boku ($35 million), TransferWise ($58 million) and Stripe ($70 million) have attracted significant amounts of venture capital, while Lending Club raised $870 million through an initial public offering.

At the front-end, there is a surge of exciting ideation, and an increasing number of smart, visionary entrepreneurs pursuing innovative business ideas. A lot of this activity is focused on opportunities that startups can easily attack using cloud computing infrastructure and anti-incumbent sentiments. Some of the markets attracting significant attention are mobile payments, peer-to-peer lending and personal finance applications.

Fierce Competition for Consumer Startups

While there is plenty of enthusiasm, the consumer market also has intense competition. This will make it challenging for investors to pick the "winners" because so many variables need to align. These startups will need to be well capitalized, build brand awareness and viral adoption, and execute at a high level. At the same time, the revenue models for many of these startups are still evolving, and it is difficult to predict how much fickle consumers are willing to pay for new services.

There is another important consideration: while consumer-facing startups have attracted a lot of attention, by definition, they are not focused on bigger, thornier problems that exist in the back-office (and often legacy technology) operations. This is a far more complex world given it involves mission critical core operations that financial institutions are reluctant to change. Some of these core systems are decades old and fragile. The technology is entrenched and deeply embedded in critical processes. The need to innovate back-end legacy systems is something we call "the silent revolution". It may not have sizzle but there are significant and necessary changes on the horizon.

We believe, however, that banks and financial institutions must embrace innovation to modernize back-end and legacy systems, while still maintaining perfect levels of reliability and availability. They need new tools to deal with the massive amounts of information they have gathered about their customers and products. They need to embrace new paradigms and architectures so they can become more agile and strategic. This will allow financial institutions to do a better job of meeting the needs of new and existing customers and, as importantly, provide them an aggressive defense against disruptive startups.

Innovation Impacting Back-End and Legacy Systems

The need to innovate has created a significant opportunity to provide capital to companies that develop new technologies that leverage the power of back-end and legacy systems using the same technologies now impacting the front-end: cloud computing, SaaS and APIs.

This is why Information Venture Partners is focused on the back-end systems market. It is a sector that we know extremely well. We have tracked and invested in it for 14 years. We have a network of world-class partners. And we believe there are complex and economically valuable problems to be solved as financial institutions look for next-generation applications. Perhaps most of all, financial institutions recognize the need to modernize and have budget and intent to invest in the next generation of back office technologies.

"FinTech has become 'sexy'," says Robert Antoniades, Co-Founder and General Partner of Information VP. "We see much of the excitement and hype centred around applications that are re-inventing the consumer experience and, to the extent possible, disintermediating the banks all together. There are and will be some very successful businesses built solving this defined set of problems. But as alluring as consumer facing FinTech is, we prefer to focus on the more complex and painful problems in the market, including applications focused on addressing financial crime, predictive analytics, customer and product profiling, payments, capital markets technologies, cyber security and regulatory or compliance applications."

The convergence of 4 powerful themes

Creating an environment for transformational change

Innovative technology is creating exciting investment opportunities in legacy and back office worlds.

1

The need to innovate has come to the forefront of the back office and legacy worlds as they strain under the weight of long outdated systems and processes. Banks, insurance companies and other financial institutions increasingly see the need to embrace new technologies to modernize and, as important, defend themselves against disruption and startups pecking away at their business.

2

Financial institutions need to be more nimble, they need to drive higher margins, launch new products, and have better customer insight. At the same time, the drive to embrace technology and innovation is being driven by executives and business units, rather than IT, which has been protective of existing and well understood legacy systems. Business unit decision makers and executives require more, better and faster access to information to grow market share, increase profits, retain and optimize their customer relationships, as well as virtually every other function.

3

In the wake of the 2008/2009 economic crisis, banks have had to deal with a seemingly ever increasing number of governance and compliance issues. As a result, there is a continuous wave of investment required to manage regulatory obligations, including technologies that make compliance less cumbersome, more holistic and automated.

4

As technology evolves, so do cyber threats to financial institutions. As an industry, financial services will need to invest and continually reinvest to protect all systems from security threats and breaches such as customer asset or identity theft, fraud and money laundering or even DDoS attacks. The adoption and purchase of new technology to address these risks are table stakes.

The Information Venture Partners investment focus

Our investment focus can be broadly defined to fit into five high level areas:

1 **CORE FINANCIAL APPLICATIONS ACROSS BANKING, CAPITAL MARKETS, INSURANCE, AND ASSET/ WEALTH MANAGEMENT.** As financial institutions look to modernize and differentiate themselves, there will be a greater need for operational and core systems that are flexible, scalable and secure. We see opportunities in areas such as loan origination and underwriting platforms, customer segmentation and optimization, scale, efficiency and analytical capabilities in the enterprise data warehouse, speed and transparency for capital markets, and products and functionality for Internet banking.

2 **FINANCIAL SECURITY AND CRIME PREVENTION:** There will be a growing need to make major investments in security amid the increasing sophistication of fraudulent and criminal attacks against financial institutions, card issuers, demand deposit accounts and automated clearing house systems. As well, the increased importance of Anti-Money Laundering (AML) legislation is requiring financial institutions to invest in transactional analysis.

3 **FINANCIAL DATA APPLICATIONS:** In many sectors, big data is becoming a strategic priority as companies look to extract better insight and intelligence from their massive data stores. A new generation of analytics platforms will let financial institutions leverage insights to shape business strategy, and enhance the customer experience.

4 **CAPITAL MARKETS:** The business transformation within capital markets through technology and operating model changes may be one of the most promising areas of FinTech investing over the next five to 10 years. Technology adopters will have an opportunity to gain market share as they disproportionately increase revenues and decrease costs in the new world of thinner trading margins and more stringent regulations.

5 **PAYMENTS:** The payments landscape has rapidly evolved over the past decade due to innovation, competition, regulation and exponential growth in ecommerce and mobile commerce. We believe the next decade will see an acceleration of innovative and disruptive products and services. Our focus will be investing in technology that delivers analytics and intelligence to the payment ecosystem.

A new, dynamic phase for FinTech investing

Conclusion

For all the excitement about FinTech investing, it is important to remember this is not a new trend. Financial institutions have been investing billions of dollars in technology. We know, as we have been investing in this market for more than a decade. We are, however, entering a new and dynamic phase for FinTech, driven by the Web, mobile and cloud computing, consumer expectations, regulatory changes and myriad other reasons. This is creating unprecedented investment opportunities for companies that can identify and develop innovative technologies to help financial institutions improve the customer experience and technology operations.

Looking for more insight about how to capitalize on FinTech opportunities?

Drop us a line:

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