Pisco Med Publishing

Case Study on the Scope, History and Scale of the Fintech Industry

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Abstract: The fintech definition and how has it evolved over time. The major players in fintech industry. Many conditions have contributed to the emergence of fintech. What are the four options that Costa could share with her client? The historical M&A data tell us about the fintech landscape. Which other alternatives could this bank focus on to create value in the fintech space? How are fintech companies valued in comparison to the broader market? What are typical multiples and why are fintech companies priced as such? What is the financial outlook for legacy banks in view of new entrants into the financial institutions space? Is panic from big banks justified or is fintech just a trend of the moment? What is the impact of fintech on banks and the financial services industry at large? How might the future look for banks and fintech companies?

Keywords: Fintech; Financial Institutions; Costa; Strategic Move; Shortcomings; Crypto-Currency Space; Scalability; Development

1.What is fintech and how has it evolved over time

The definition of Fintech[1] is very broad as the case study details. Taking a look at the word itself it is an amalgam of two words financial and technology. In summary, Fintech can be used to define any novel technology made to improve the use and delivery of financial services. An example is a technology that enables this service delivery to gain autonomy.

Fintech is concerned with assisting corporations, small business owners and individual consumers to manage their finances much better. It does this by making use of specialized algorithms and software ran on computers and more recently smartphones. This area of finance emerged in the 21st century and has undergone several evolutions, as is the nature of technology.

Its application started at the backend systems of large financial institutions, where it was utilized in speeding up tedious repetitive tasks. Fintech then moved to find use in many consumer-oriented applications, which changed its early definition. Fintech continued to find uses in other diverse areas of the finance world as computing power continued to grow and improve. Some of these sectors include retail banking, non-profits, education, investment management, fundraising and much more.

One of the most notable and disruptive developments enabled by Fintech is the emergence of crypto-currencies. These are digital currencies that are based on decentralized blockchain technology secured by cryptography[2]. Examples include bitcoin, etherium and dogecoin. New crypto-currencies are emerging every other day.

The emergence of Fintech has been facilitated by multiple factors that had to coalesce and develop it to the point it is at today. This includes the rapid advancement in computer processing speed, miniaturization of processors, wide penetration of computer devices and their acceptance in society. The increasing demand for flexible and more efficient financial services has also aided the emergence of Fintech. The new generations have high expectations that institutions are forced to meet.

Eased regulation and lack of foresight in the existing regulations was also vital in giving Fintech a chance to exist in many areas. Many of the regulations had no Fintech clauses making it an almost completely unregulated area of finance. The Fintech start-ups took full advantage of this lack of regulation and grew their capitalization very fast before the authorities had a chance to rein them in. The potential to make huge returns also attracted investors to the Fintech space.

Increasing complexity in finance operations and offerings has necessitated the application of Fintech. In areas such as risk assessment in lending activities, there is a multitude of factors to consider which were strenuous for humans. Another is in equities markets where Fintech has simplified trade analytics. To surmise Fintech has emerged from necessity in the developing financial environment[3].

2.What are the four options that Costa could share with her client

The first option Costa could present is the option to do nothing. This means that the bank will continue with its current business practices and ignore the Fintech space. The advantage of this proposal is that it is very easy to enact. It requires no input from the bank other than turning a blind eye to developments in the Fintech space. Of the options tabled this will be the cheapest by far. This option also preserves most of the existing jobs at the bank since fewer employees will be at risk of losing their positions. The ones who will be at the most risk will be the managers responsible for the decision.

Doing nothing also presents several disadvantages. This includes the risk of the bank being obsolete and archaic in the modern financial space. Not adapting to emerging technology will lead to a reduced number of new customers who will be attracted to the more adaptive competitors. This choice also greatly reduces the growth potential of the bank.

The next choice Costa is putting under consideration to place before the client is purchasing a Fintech start-up. This is a much pricier option than the first option. The valuation of Fintech firms is quite high in the current equities market. Another difficulty the bank may encounter is finding a firm that will serve their specific needs as a corporation. The firms available for purchase may not be suited to complement the needs the Bank has. There also difficulties with acclimatizing the employees who come with the purchase, considering conflicting work-environment cultures

The upside of purchasing a Fintech firm is that it comes with established infrastructure and personnel, thus reducing work the Bank needs to do. Purchasing a Fintech firm also presents an opportunity to gain new clients in the form of the firms existing customers[4]. This option also presents an opportunity for the Bank to diversify the services offered, which would improve its revenue stream. There is also a current boom in Fintech start-ups meaning there is a larger variety of firms now more than ever. This would be the best time to make a purchase and find a complementary firm.

The third option presented to the Bank is the strategic move of converting their existing IT infrastructure and become a Fintech company themselves. This is a move other banks have made to stay relevant. The opposite is also true with tech companies moving into the financial space by incorporating Fintech to their operations. The Bank taking this route presents several advantages. The greatest is developing Fintech that will meet its specific needs perfectly. This will be a much more organic process than purchasing a firm. Enabling the employees to gradually adapt to the changes where it may have come as a disruptive shock otherwise.

The shortcomings include the fact that it will be a time-consuming process. It will also be expensive to implement, requiring an extensive overhaul of the IT infrastructure. Changing the public perception of the company will also be an uphill task that may require a large marketing budget.

The fourth and final option is to partner up with Fintech firms to serve customers. This measure is kind of midway point between firm acquisition and the firm morphing into a Fintech company[5]. It is an option that will enable the bank to enjoy the benefits of the two options and negate some of the disadvantages. Partnering will allow the Bank to explore a variety of options to find the one that suits it best. It will also allow the Bank to be at the centre of a Fintech ecosystem that will be greater than its individual makes up.

The disadvantage may come in with the contract negotiations, which may include limiting stipulations such as not allowing the Bank to work with other Fintech companies. Finding the right partners to meet the full potential of the ecosystem is a trial and error process. Analysing all the four options it is clear the final option proposing a partnership ecosystem is the best choice.

3.How are fintech companies valued in comparison to the broader market

The reason for this is that it is the most efficient way to harness the Fintech potential. It would allow the Bank to be a big player in the Fintech space in a relatively short time. This option allows the bank to build a great reputation for being forward-thinking and providing the best service to customers. Besides, the option will allow the Bank to offer the widest variety of new improved financial services at an economically reasonable price. The Bank will gain from multiple partnerships if it can be strategically managed. Placing the banking the middle of a Fintech ecosystem will also enable it to be in step with the latest developments. It may get chances to launch innovations that could pay out in a big way.

Looking at the M&A data presented in the case study we can note a few trends. The data show that different subsectors generate varying interest in M&A deals. Payment processors maintain the highest interest while payroll & admin as well as banking solutions the lowest[5]. This indicates that financial institutions have a greater need for Fintech start-ups that facilitate payment processing as well as insurance and healthcare solutions. The graph also shows there was steadily declining interest in closing deals for Fintech start-ups between 2011 and 2013. This dramatically changed in 2014, the cause of which could be several reasons.

Some of the alternative options the Bank can look at to create value in the Fintech space is the crypto-currency space. Traditional banks have been unwilling to accept this new form of currency. All factors indicate that it is here to stay. The bank could be the first to provide solutions to some of the challenges facing crypto miners and institutions that accept it as a form of payment. The sector holds the greatest potential for growth in the Fintech world.

Considering the valuation of Fintech companies in recent times it is noted that, they are valued much higher than other start-ups. This has been a growing trend since the emergence of the first Fintech companies. The valuation multiples can be shown below.

EBITDA Margin			EV/Revenue			EV/EBITDA	
Processors	18%		Processors	2.25		Processors	12.5
Software/Hardware	11%		Software/Hardware	3.4		Software/Hardware	12
Bank	17%		Bank	4		Bank	19.5
Investments	31%		Investments	4.75		Investments	15
Insurance/Health care	6%		Insurance/Health care	3.1		Insurance/Health care	12.5
Outsourced	22%		Outsourced	2.75		Outsourced	13.5
Payroll/Administrative	10%		Payroll/Administrative	2.25		Payroll/Administrative	19.5
Content	22%		Content	3.6		Content	16.5

Data source: Mercer Capital, "Value Focus: FinTech Industry," 2015, http://mercercapital.com/assets/Mercer-Capital-2014-Q4.pdf (accessed Nov. 2, 2016).

The reason that Fintech companies are valued at such a premium is due to their scalability[6]. Fintech companies are technology companies at heart and like other technology companies; they can grow in a manner that does not require as much additional investment as other start-ups. Fintech companies also have high return potential since they are not burdened by the limitations traditional financial institutions face in form of regulation.

4. Financial outlook and the impact of fintech on banks and the financial services industry at large

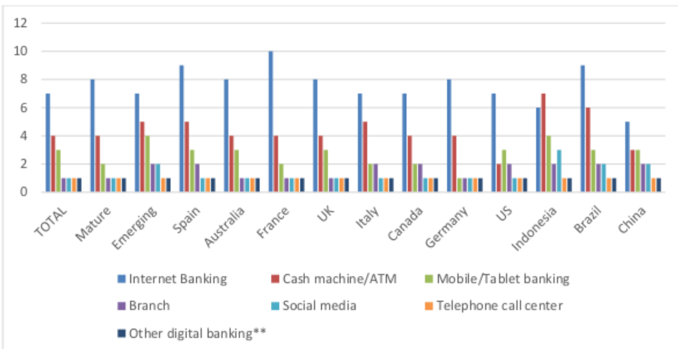
The financial outlook of the existing banks in the face of emerging Fintech companies into the same space as them is not positive. There is data suggesting that the new player in the field could take away a significant chunk of the legacy banks revenues in the sectors they are competing in. This situation is a result of the Fintech companies being much more efficient and convenient in-service provision[7]. One of the top bank executives at Goldman Sachs was quoted saying, "Goldman Sachs estimates that upstarts could steal up to $4.7 trillion in annual revenue, and $470 billion in profit from established financial service companies."

The disruptive power of Fintech companies in the financial world has the legacy institutions quaking in their boots. This, however, should not be the case. Change is inevitable and a vital part of our world. The legacy banks should turn this initial shock into motivation to adopt and go with the times. The Fintech revolution presents several new opportunities that these legacy institutions stand in prime position to take advantage of.

The legacy banks have immense financial power that can be leveraged to partner up with the Fintech start-ups. An established bank that can embrace this technological revolution stands to increase its revenue beyond what it could achieve sticking with the traditional methods. Fintech should not be viewed as a trend but as the next step in the development of the finance industry. Tech is disrupting many areas of our lives; it is an inescapable part of our reality.

The impact Fintech has had on financial services and banks, in general, is quite significant. The most visible change that has occurred in the manner in which the customers interact with the financial institutions[8]. There has been a dramatic shift in the use of banking halls; they have become more consultative lounge spaces. The chart below shows how customers interact with banks.

Figure 7. Number of interactions with main bank every month by channels.



All factors are pointing to more integrated systems in the financial space. Fintech will get better at providing financial services and become one with the legacy institutions. This will be to the benefit of everyone involved.

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