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Fintech: Competitor or Collaborator?

Disruptive Forces in Investing

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Anu Rajakumar: Welcome "Disruptive Forces in Investing," a podcast from Neuberger Berman where we discuss innovations and industry trends relevant to investment portfolios. I'm your host, Anu Rajakumar, and today's episode is about the intersection of finance and technology, also known as Fintech. You'll hear a discussion on the evolution of Fintech and its various subsectors, how Fintech has changed consumer behaviors, security, and the role of regulation, and where investors should look to find the next big disruption in Fintech. I'm joined today by Charlie Murphy and Scott Woodcock, who are senior research analysts in Neuberger Berman's Global Equity Research Department. Charlie and Scott, thank you for being here.

Charles Murphy: Thank you for having us, Anu.

Scott Woodcock: Thanks for having us.

Anu: So Charlie, in 2016, the Oxford Dictionary officially recognized Fintech as a word. So by then it was already totally mainstream. Could you define what is Fintech and tell me a little about the evolution of the space.

Charlie: Sure. So, we see fintech as the collision of financial services and information technology. It's the application of key advances in technology to transform financial services as we know it today. The last ten years have seen enormous advances in consumer facing technology. So, think about your phone, how you shop, how you consume entertainment and news, how you store your photos and share your experiences. Despite that, many parts of financial services are still doing business the exact same way they were 10, 20, 30 years ago. That's the opportunity, in our opinion, for disruptive fintech companies. Over the next ten years, we think the same type of digital disruption that rocked let's say the media industry, or the retail, or travel industries is coming for financial services. We think it's already happening, today, in many areas. Financial services globally is a massive global profit pool to attack. And it often has low consumer satisfaction. What we expect in the years ahead is that successful financial services companies, both new ones and existing ones, will use fintech to gain market share and the providers of fintech we think will continue to enjoy robust demand for their products and services. As we think about why is this happening, we see four key catalysts that have brought fintech to the fore. No. 1) Cloud computing. You can scale up good ideas far faster and cheaper than 10 years ago. No. 2) Big data analytics. You can discover new insights and introduce products far faster and cheaper than years ago. No. 3) Global smart phone proliferation. This is a massive three-billion-person distribution system that didn't exist ten years ago. And fourth, a surge in venture capital funding post the global financial crisis. That's important because a lot of companies that receive this funding are now approaching or are at scale, where they're really disrupting incumbent financial services companies.

Anu: And just speaking for myself, I think the conveniences that I've been afforded today, just by tapping on my phone for lunch or transferring funds with just a couple of clicks from that seamless experience that you talked about, Charlie, I think it's probably changed my spending behavior. So Scott, just wondering, what are some of the big trends that you think have affected society thanks to the technological advancements in finance?

Scott: Yeah, I think, Fintechs, as it applies to financial services, have been driving the trend of consumers expecting a better customer experience. Both from the interface, I think Fintechs have been really helpful in terms of focusing the financial sector on innovation and creating a really good consumer interface and interaction and then just the reliability and the omnipresence of financial services, the fact that you can check your bank balance 24/7, that you can shop from bed or just the fact that the technologies are always around you and they always work.

Anu: The late night Amazon purchases that you didn't mean to do.

Scott: Yeah, exactly, exactly.

Anu: Yeah.

Scott: So it could be good or bad. But, but I think it's really elevated consumer expectations and I think Fintechs have been instrumental in pushing the financial sector to innovate. And I think that's something that's really come about in the past five years or so.

Anu: Charlie, you mentioned Big Data earlier. How has Big Data helped companies to better understand, improve and personalize the customer experience?

Charlie: So there's a ton of data being created every day across our smartphones, across all of our devices. Some of our companies are measuring literally how good of a driver you are and sending that data back to your insurance provider and your bank. There's no question that data is exploding and will continue to. What companies are struggling with is "how do we use that data to become better." And so lot of the companies we look to invest in are companies who have attempted to figure that out. And it can be across a number of things. So one example that comes up is, let's say five years ago it took a mortgage company about 90 minutes to process a mortgage application. One company we follow has designed an AI-assisted program to take that down to five minutes today. And in a year or two from now it'll be less than a minute to process a mortgage application, so you can see just tremendous productivity savings to the end client.

Anu: Now obviously this is a space with some massive incumbents. So let's talk about the incumbents vs. the innovators. What are you guys seeing? Adaption, acquisition, collaboration, or displacement?

Scott: So we're seeing a little bit of all of those. You see some companies that are focused on disruption and some that are a little bit more collaborative. I would say that more kind of disruptive model was more of a focus several years ago where companies were really trying to come in and shake up the industry and be really disruptive. I'll give one example of that. The Lending Club, for example, within the peer to peer lending space. This was a really disruptive model and really would've disintermediated the banks because what they were trying to do was directly match people that wanted to borrow money on one side with people who had money to invest and wanted to earn a return on it on the other. So this was a peer to peer lending model and it created a lot of excitement at the time but then it ran into the problem they weren't really able to fund all of the loans that the platform was generating with the funding that they were raising on the platform. So, there was a problem with the model, and they had to adapt by seeking other funding sources from banks, for example. So that's something you've seen with a lot of the disruptive models is that they often ran into a problem of some sort and were forced in the end to work with and collaborate with other players in the industry. So it's been interesting to watch in the space, as the ways that companies are looking to participate in the ecosystem have kind of changed and you see a mix of cooperation, disruption, and adaptation.

Anu: Sure. And I'm sure there are probably advantages with being digitally native companies. What benefits are there of being an emerging Fintech company that's digitally native vs. kind of an incumbent institution?

Scott: Well, you don't have any of the legacy infrastructure. So a lot of old banking products were built on mainframe computers and you're kind of stuck with having to maintain that while you're running those products. So if you're digitally native, you can start everything in the Cloud, you can use the modern technology and it just makes your technology stack a lot cheaper to operate and it also allows you to iterate your product more frequently and get newer products to market more quickly. So it gives you a lot of advantages in that regard.

Charlie: And just to level set, I think one key problem Fintech is trying to attack is today still a lot of financial services are expensive, they're confusing, they're paper based, and they're people based. And successful Fintech companies will attack that problem very aggressively. So I remember 10 years ago or so, the first time I got a mortgage, there was a stack of paper about two feet high, it was extremely intimidating. You know, five, 10 years from today, that would be a completely different consumer experience.

Anu: I will welcome that day. Can you talk a little bit about the role of regulation here? How do regulators balance the potential public benefits of financial innovation with the risks in an industry where security and fraud can be really problematic?

Charlie: Financial services is always going to be highly regulated in my view. And so the companies that can adapt to the existing regulatory structure and get ahead of what problems their innovations may cause, are going to be the champions in our opinion.

Scott: In fact, that's the business model for some companies, being able to navigate the regulatory environment and deal with the different regulatory regimes worldwide. Sometimes that's the competitive advantage that the companies have and it also creates a little bit of a moat for some companies, that if you have a competency of dealing with different regulatory regimes in different geographies, then that's something that a pure technology company might not want to get involved with and it kind of keeps them out of the market.

Anu: Now, Scott, your focus is on the payments industry. I have read that Sweden will become the first cashless society in 2023 when it stops accepting cash altogether. Is that the future for us all, and what are some pros and cons to think about, if that's the case?

Scott: Yeah, I tend to think that most countries will move towards less and less cash in their systems over time, but I don't think every company will end up like Sweden with no cash at all. I just think it's very difficult in a number of countries to imagine that given the technology as it exists in those countries today that it could get to that point. But you know, I do think that the growing penetration of electronic payments is something that is likely to be a trend for some time. Some of the implications of that are on the positive side I think it increases efficiency, eliminates the potential for a lot of black market activity, for example; a lot of governments find it helpful in that respect. One concern that governments need to be mindful of and other participants in this space is financial inclusion and making sure that you don't have consumers that are left behind as a result of the need to use technology for payments. So there are a number of players that are working on that. So it's something that I think is a problem I think can be solved but it's just something that definitely needs to be born in mind as we move towards a cashless society.

Anu: Now at the time of this recording the U.S. economy has set a record for the longest expansion in American history. But with that comes more and more concern about how and when the cycle might end. So knowing how financial institutions fared in 2008, what can investors expect from Fintech companies should a recession come around?

Charlie: That's a good question. So some of the companies we invest in, particularly in the analytic space, are pretty well positioned to grow kind of regardless of the economic environment. And what I mean by that is number one, the way their businesses are set up are very high recurring revenue models, some of them upwards of 80 percent revenue, just contractually set at the course at the beginning of a year. And they also tend to be a pretty low ticket item for the end customer but provide enormous value to them. So they're the last thing the client would try to unplug in the event of a downturn. And so that's pretty attractive. We think some of these companies are going to grow nicely in any environment. In some of the companies we invest in some of them have some counter-cyclical revenue streams that are today pretty depressed as you might imagine, that would rebound nicely if the economy were to deteriorate. I'm thinking of, for example, some of the analytics companies I look at are very good at spotting early problems in banks' customer portfolios that they wouldn't be able to see just looking at their own portfolio because they can see the entire ecosystem around that bank. And so as you can imagine, that type of data becomes enormously valuable as the economy starts to deteriorate.

Scott: And we talk about this a lot. I mean we think a lot of the companies in the space have some of the best business models of any companies out there in terms of the visibility of the revenues, the recurring nature of the revenues. So we think that's something that'll serve the Fintech space broadly well as we move into a tougher economic environment if that happens.

Anu: Yeah, it is very difficult at this time. Maybe as investors look for opportunities to profit from the megatrend, aside from the financial institutions and financial companies themselves, are there any indirect beneficiaries of advancements in Fintech, either up or downstream?

Charlie: So we can think of a few. First of all, and this maybe be obvious are specialty consultants. There's a global supply shortage today of IT knowledge, but IT knowledge coupled with financial services industry expertise there's going to be really robust demand for that for the next several years, in our opinion, benefiting those type of companies. Secondly, another maybe less obvious example are data center companies. Data will continue to explode in our opinion over the next many years and financial services companies are going to have to introduce new products as fast as they can and be connected to their customers at all times. Data center companies are key enablers of that secular trend. Lastly, we think certain semiconductor and hardware companies that manufacture key products or platforms for fintech will also be surprising beneficiaries in our view, particularly in areas like blockchain which is seeing a tremendous amount of research and development in Asia today. An example of a company that could be an indirect beneficiary of fintech is actually Facebook who recently launched a blockchain-based technology called Libra which has been garnering an enormous amount of attention around the world. If they're successful in Libra, this could evolve into a new global payment system especially in parts of the world where established payment infrastructures don't exist today. Now there are still a ton of questions about this project and as you'd imagine, regulators are exploring it aggressively, but we're watching that closely to see if it can develop into a meaningful global payment system over the next three, five, ten years.

Anu: Obviously this is a global phenomenon. Where in the world have you both been seeing the most exciting advancements in Fintech?

Charlie: So China, certainly one area that's super exciting in our opinion. We have analysts on the ground in Hong Kong. They're talking to both established companies and startups about some of these interesting developments in Fintech. I remember a couple of weeks ago seeing Jamie Dimon speak at a conference saying he had just been to China a few weeks ago and went to see two of the major Chinese Fintech vendors to kind of understand where the cutting in Fintech was, which I thought was fascinating. There's a company we look at who uses facial recognition technology to ensure that their agents aren't committing fraud or being too aggressive in their –

Anu: Just from facial expressions.

Charlie: Exactly. Just looking at the emotion in their face, which is fascinating and a little scary.

Scott: Yeah, but I think it's fair to say that there are interesting companies that are doing really interesting things in Fintech around the world. You can think of examples in Europe, Latin America, Canada, Asia, really around the world, apart from the U.S. and including the U.S. So it's one of the things that's kind of exciting to work in this space, is that there's just such a variety of companies in different markets that are applying solutions in different ways.

Anu: Well, Charlie and Scott, really appreciate you taking the time to share your insights on the interesting world of Fintech and how companies are competing to make traditional financial services more nimble and accessible. And to our listeners, thank you for joining us for today's episode of Disruptive Forces. If you like what you heard, I hope you'll subscribe via Apple Podcasts or Google Play. For previous episodes as well as more information about our firm and offerings, please visit www.nb.com/pocasts.

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