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Opportunities looming in the financial technology startup jungle

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The financial services sector, long known for its conservatism and lack of innovation, is facing a revolution driven by companies inventing new efficient ways to execute the tasks many feel are too slow, complex and costly.

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Mobile games are capturing the attention of many technology startup followers, but behind the sparkle and glitz of the entertainment focused consumer services, another class of serious startups are building momentum. The financial services sector, long known for its conservatism and lack of innovation, is facing a revolution driven by companies inventing new efficient ways to execute the tasks many feel are too slow, complex and costly.

Despite the complexity of the industry, with its extensive regulations, high barriers of entry, and apparent economies of scale, intrepid entrepreneurs are making inroads and coming up with new solutions, services and business models that are rapidly gaining popularity. It is not only the incumbents and startups that are joining the battle, companies from adjacent or entirely new industries are jumping into the frenzy. While it is a jungle out there, it seems evident that some of these players will emerge as big time winners. But just as there will be winners, the brutality of this evolution will also leave a lot of the attempts as smoldering wrecks after the battle is over.

It is a world of difference

The 2008 credit crisis opened up a window of opportunity, which fueled the entry of a number of new startups.These new ventures became commonplace both in the credit and prepaid credit card market. The turmoil around the financial crisis in some way may have been the final straw for many people, causing them to relinquish their last fate in large financial institutions and give the new players a chance. This development was particularly prevalent in the US, where new solutions for credit and payment rapidly proliferated.This trend has then continued into retail and consumer payment, with Google (Google Wallet) and Apple (Apple Pay) entering the market in a big way, as well as chatting application players such as Snapchat (launching Snapcash together with Square, a player deep in small-scale retail). Similarly EBay and Paypal have entered mobile payments through Venmo.

More recently, as chatting applications have become a standard of communication in many regions, this has driven a further boost in new financial services. The reason is simple: user friendly chat applications with a large user base connecting friends, family colleagues and, more recently, businesses offer an ideal breeding ground to test and launch new services, and in particular financial services. The battle for mobile payment and money transfers is currently raging in Korea, where large players like DaumKakao and Naver have entered, along with companies such as Yelopay (working with none other than Samsung), and some smaller startups financed by eager venture capitalists. For anyone who has experienced the complexity of online banking in Korea, it comes as no surprise that this area is getting attention. Given the high penetration of chatting applications, and the need for the companies behind these services to find new ways of driving revenue, the market has been ripe for quite some time and has now entered a highly competitive and somewhat overcrowded stage.

In Asia firms like Accenture are actively promoting financial technology startups. Accenture, in collaboration with large financial institutions, are boosting the sector through the FinTech Innovation Lab Asia. Recent finalists covered innovation areas such as credit analysis, data protection, identity authentication and quantum computing (a hot topic not only in fintech). This and other similar events highlight the diversity that exists in the financial technology sector.

Across Africa, India and South East Asia, mobile solutions are rapidly leap frogging traditional banking. Mobile payment, branchless banking services and other ways to bring financial services to people who previously have been unbanked are growing rapidly. It is not only startups driving this, governments and telecom companies are also highly involved.

Financial technology is clearly a global phenomenon, and mobile technology is a key driver. However, to fully understand the depth and diversity of fintech, the place to study is London, UK. Long the European financial center, the city is bustling with activity. With global investment in financial technology hovering at 3 billion USD, it appears over 50% of the European investments in this sectorare made into UK and Ireland. The technology companies here are not only working on credit and payment, many also address back-office operations and functions such as customer service, project management and logistics. With this development continuing, the next years will see the conservative financial sector changing it shape, bringing new solutions and unprecedented efficiency for all involved.

This section would not be complete without the mentioning of bitcoins. In finance it is not only the processes and services that are being reinvented, the whole concept of currency is taking on a new meaning.

Show me the money

To see the big picture of financial technology, it is helpful to define a framework of the various parts of this ecosystem. In the grand scheme of things the companies can be classified into four major categories:

1. Payment, banking and billing – including both online, mobile, traditional payments and core banking
2. Credit – covering areas such as scoring, decision analytics, alternative lending, credit collection and debt purchasing
3. Capital markets – which includes exchanges, brokerages, trading, post trade admin, risk management, buy side solutions and data service

4. Financial and business services – including consumer portals, product distribution, market research, intermediary services, business process outsourcing and corporate financial software

In practically all of these areas technology can play a big role in improving efficiency. The big players, partially due to being bogged down by evergrowing legacy, have not been very good at innovating and improving their processes or solutions.

Torch Partners in London, UK, makes a good overview of the fintech landscape, and in particular describes how the market values the various categories of the ecosystem. Using metrics such as entity value over EBITDA (earnings before interest, taxes, depreciation and amortization, basically describing the value of the company over its profits) they show multiples ranging from 4x up to 26x. Meanwhile, the revenue CAGR (compounded annual growth rate) ranges from 4% up to 28% among the main players. Not surprisingly, given the large size and winner takes all nature of the sector, payments, banking and billing related players command the highest multiples and the highest CAGR. However, with the exception of payment networks, their profit margins are not as high as some of the other category players (at least as far as the year 2014 is concerned). It is the capital markets category players who seem to command the highest profit margins, but due to somewhat slower growth their multiples stay in the midrange, similar to the multiples of credit players. It is interesting to note that financial and business services category players are well spread out across the value map. The diversity of this category of players makes multiple ways of value creation possible.

The key point of this value creation perspective is that while some categories of players get a lot of hype about them (such as mobile payments), this is also the area where there are only a few winners (and consequently, a lot of losers). Within the financial technology arena, there are many areas where a company can specialize, however. For an entrepreneur it most certainly makes sense to get a deeper view into the diversity of this ecosystem and the opportunities it presents, before jumping in.

What to expect

The public debate about fintech is quite focused on the big battles in mobile payment and banking. It is understandable, since this is the category of players which most people know, and which therefore is an easy topic to debate. However, as is shown above, fintech is a very broad sector, with a large variety of activity globally.

The financial sector is one of the areas where technology can have, and is having, profound impact. Most areas are ripe for substantial improvement, and the incumbent players are not in a position to actively pursue all the potential innovations. However, a lot of this revolution will happen behind the scenes, unnoticed by media, yet driving substantial value creation for the companies focusing on areas others have not noticed. The media attention being on the big battles tends to skew the full picture, focusing only on the “rock star” battles. These are battles of few winners and many losers, however, being overcrowded and overinvested.

Since Korea does have an active financial sector, great mobile, IT and broadband technology, and strong software skills, one might hope a more diverse group of fintech players to emerge. Companies who would truly solve global problems in the sector in a new way, and find a way to make a mark in the financial sector worldwide. This could both drive the Korean financial sector forward, but also support the quest for creative economy, which is badly needed for Korea to continue its economic advancement. This type of companies require, however, people with deep insight and skills in the financial sector, its processes, and the available technologies. Korean companies have all the elements for success available, but the starting point must be to raise the bar above the local issues and look for ways of finding solutions for problems bothering the larger Asian region, or potentially the global financial sector.

No matter which companies emerge from the jungle as winners or survivors, the coming years will be a massive transformation of the financial sector as we know it.

Further reading and references

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