ClearBridge Investments

The New Normal: Fintechs Transforming Digital Payments

February 23, 2021

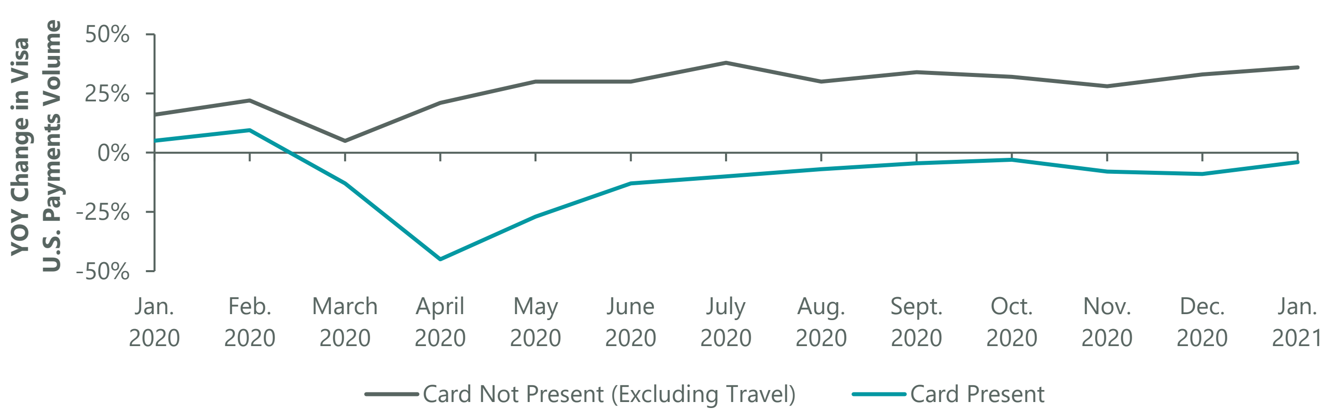
Key Takeaways

- Financial technology companies have played a key role in enabling and enhancing digital payments for consumers and businesses during COVID-19 lockdowns, increasing the ease of online and mobile transactions and digitizing formerly manual processes.
- Abundant liquidity and investor demand have created an exuberant IPO environment for innovative fintechs. Many of these companies are being buoyed by investor momentum and their business models, though growth profiles could be tested as the economy normalizes.
- Big banks have also stepped up their technology investments to create more robust mobile and digital experiences for customers and payment networks are continuing to partner with innovative fintechs.
- In some markets outside the U.S., lack of existing infrastructure and supportive regulation have led to the creation of new mobile-phone based networks and payment providers.

Innovative Payment Options Spawning New Growth Markets

The explosion in e-commerce since the onset of the COVID-19 pandemic, as well as forced physical separation, have accelerated an already evolving and expanding digital payment ecosystem in the U.S. and globally. We expect the momentum built up over the past year to further hasten the shift away from cash and checks by consumers and businesses (Exhibit 1), creating opportunities for financial technology (fintech) companies to increase the digitization of payments by enhancing their convenience and efficiency.

Exhibit 1: Remote Card Payments Have Increased During Pandemic



Data as of January 31, 2021. Source: Visa.

Scores of fintechs have taken advantage of faster growth to come public in response, with more highly valued private players preparing to join them through initial public offerings, mergers with SPACs, and in some cases, M&A activity. Existing and newly public digital payments and processing companies, as well as established financial companies, are focusing on speed, simplicity and capturing and utilizing more data in transactions to provide more value to customers.

Consumers have More Choices in COVID Era

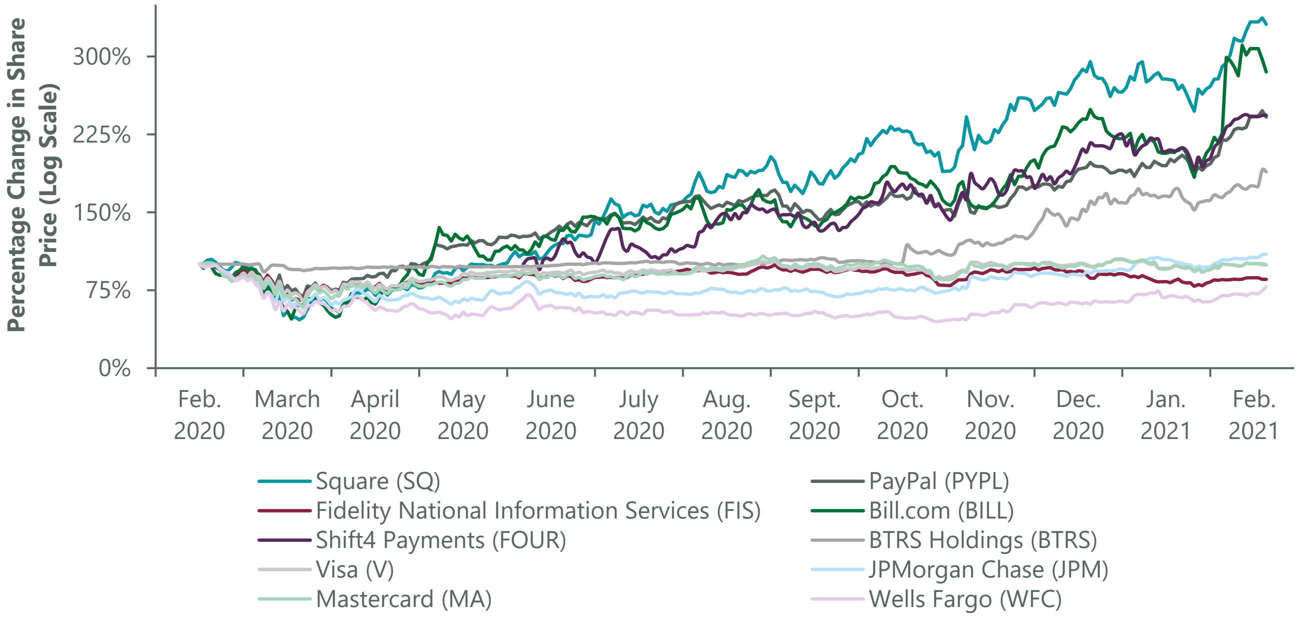
On the consumer side, digitization is spreading from the younger and more technology savvy generations to the broader population. Even baby boomers who have traditionally visited banks and sent check payments through the mail, for example, are now ordering groceries online and depositing checks with their mobile phones. The U.S. Treasury is distributing stimulus payments electronically, loading them onto prepaid debit cards. Meanwhile, buy now, pay later (BNPL) companies are growing rapidly, supporting purchases of millennials and Generation Z consumers.

During the global coronavirus pandemic, many payments/fintech companies have experienced explosive growth in customers and customer transactions. Some of the biggest winners have been Square, Shopify, Adyen, and PayPal. Square's Cash App has seen strong growth as many underbanked consumers sought ways to receive and manage their stimulus payments. PayPal benefited from increased online (card not present) spending and its Venmo and Xoom units benefited from new users, including many older citizens, who needed ways to receive and send money without personal contact. PayPal and Square also attracted new customers and saw increased engagement from offering customers the ability to buy and sell cryptocurrencies. Other fintechs serving fast growing online businesses such as Canada's Shopify and Netherlands-based Adyen also experienced significant business and share price growth during the pandemic.

Companies offering BNPL services – the 21st century version of layaway – have also seen very strong growth and greater appreciation by consumers and investors. These fintechs offer merchants – many of them online – a higher probability of incremental sales by providing customers a short-term financing option before or at checkout. Australia's Afterpay and U.S.-based Affirm, which went public in January, are among the better performers among fintech companies year-to-date. Sweden's Klarna, still privately held, is also a leading player in BNPL and PayPal is expanding its Pay in 4 offering to more of the millions of merchants it serves.

Shares of some newly public consumer-oriented fintechs are soaring due to rapid growth and strong investor demand likely helped at least in part by an abundance of liquidity in capital markets and investors' focus on fast growing companies (Exhibit 2). Many of these high-growth companies will likely face a test of their business models as the economy normalizes.

Exhibit 2: Fintech Valuations Have Soared Relative to Banks, Payment Networks



Data as of February 17, 2021. Source: FactSet.

Amid the fintech boom, big banks JPMorgan Chase, Bank of America, and Wells Fargo are not standing still. Instead, they have continued to invest tens of billions of dollars in technology research & development to augment their digital and mobile banking services for consumers and businesses. Post the pandemic, more widespread acceptance and adoption of digital banking services should allow the big banks to reconfigure and close a large portion of their physical branches as they re-engineer customers' experiences. Branches that remain will likely be modified to be more efficient and probably smaller. That said, banks are likely to continue to open new branches as they expand into new markets.

Citibank, which has a smaller branch network than competitors, sees itself as particularly well positioned to compete digitally. Citi is one of many banks and fintechs seeking ways to better serve consumers and businesses digitally. By using technology and data, firms seek to deliver increasingly customized and targeted services, looking to replicate the customized experiences consumers receive from companies such as Amazon and Netflix. In the future, more banks and fintechs will serve their customers by using predictive models to make product and service suggestions. The largest banks are investing to improve service to their commercial customers as well.

B2B Providers Enabling E-Commerce, Reducing Complexity

Another area of payments impacted by pandemic-related changes, including work-from-home, has been business-to-business (B2B) payments. B2B is an enormous addressable market as illustrated by the five-step payment process (Exhibit 3). Not only are software and related services playing a critical role in businesses acquiring new customers, but technology is increasingly being used to help businesses more efficiently process payments and improve the efficiency of payment transactions for both customers and suppliers. B2B payments is a segment with a number of fast-growing companies, both public and private, on which the payment networks are also focused.

Software that can integrate with existing business accounting and banking systems is difficult to create, and if usable by large numbers of customers, provides a big growth market. Companies like Billtrust, which was taken public through a merger with a SPAC completed in January, provide this customization for accounts receivable.

Exhibit 3: Opportunities at Every Step of Digital Payment Process

Source: Company reports, ClearBridge Investments.

Work-from-home during the pandemic forced many businesses to establish an online payment system for the first time or add sophistication to an existing system. Other companies such as Bill.com and privately-held AvidXchange and Mineraltree help businesses manage accounts payable by automating invoices, payments and collections, an evolution which has become even more important with most business accounting teams now operating from home with no easy way to mail or process paper checks or route documents for approval.

To play a role in B2B digital payments, fintech companies sometimes use the rails of payment networks Mastercard and Visa in addition to ACH rails and in some instances, checks. The networks have continued to innovate, supporting the growth of B2B payments as well as expanding electronic payment options to underserved markets in the U.S. as well as emerging and frontier markets that often lack an extensive banking infrastructure. Today, they are partnering with smaller fintechs to help them more easily integrate their software with the Mastercard and Visa networks to speed their ability to serve customers.

Some physical merchants face challenges from complexity and are making changes during the pandemic to address them. Shift4 Payments, which went public in June 2020, helps mainly hospitality merchants streamline the acceptance of payments throughout their facilities. Meanwhile, fast growing Nuvei, which also had its IPO last year, helps simplify pay in and pay out for gaming providers.

International Markets Disrupting Traditional Payment Infrastructure

Outside the U.S., digital payment innovation is occurring out of necessity and/or opportunity. We have seen a lot of innovation in developing countries because many lack the well-established, efficient payments infrastructure present in most Western countries. That lack of payments infrastructure has caused India and many other less-developed markets in Africa and Asia to leapfrog card-based consumer payment systems in favor of other, often closed, mobile phone-based payment systems. Over time many of those closed systems have been opened up to accept payments from many of the well-established systems outside developing markets. Among more developed countries, digital spending accounts for more than 80% of all payments in China, South Korea and Sweden. The U.S. sits at about 70%, Germany is about 20% digital while Spain and Italy, emblematic of Southern Europe, are at about 15%.

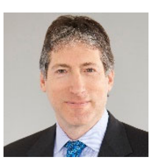
In many markets, payment solutions providers – including some closed domestic schemes – now use Visa or Mastercard's payment networks as a much less expensive alternative to expanding existing or building new networks. Even in China, where ubiquitous payment schemes such as Alipay and WeChat Pay have been developed, these formerly closed networks have opened up to accept Visa and Mastercard payment credentials to enable foreigners to easily make payments in China. In many developed markets, such as some in the EU, banks that have traditionally played the role of acquirers have lost share to focused providers like France's Worldline and Netherlands-based Adyen. Both make it easier for companies to accept electronic payments.

China has been a source of innovation in consumer payments due to limited initial regulation and a lack of existing infrastructure. The situation in China has changed recently though with the government becoming increasingly active in regulating and controlling the activities of Alipay/ANT Financial as they have expanded beyond their basic roles as payment platforms.

Regulators in Brazil have not only tolerated new payment providers, they have been encouraging their development. Regulators in South America's largest market have taken action to support competition for the large banks that have traditionally generated high margins at the expense of consumers or businesses. This has been favorable for newer digital payment providers and has helped drive the success of payments companies like StoneCo which initially served small and medium-sized enterprises and is now targeting larger businesses as well.

Whether through innovation, supportive regulatory environments, the need to serve new markets due to the COVID-19 pandemic or a lack of traditional payment systems, fintechs all over the world are hastening the move to digital payments. These companies are facilitating the growth of e-commerce, streamlining the B2B payment process and creating investment opportunities in both new and established industries.

About the Author



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