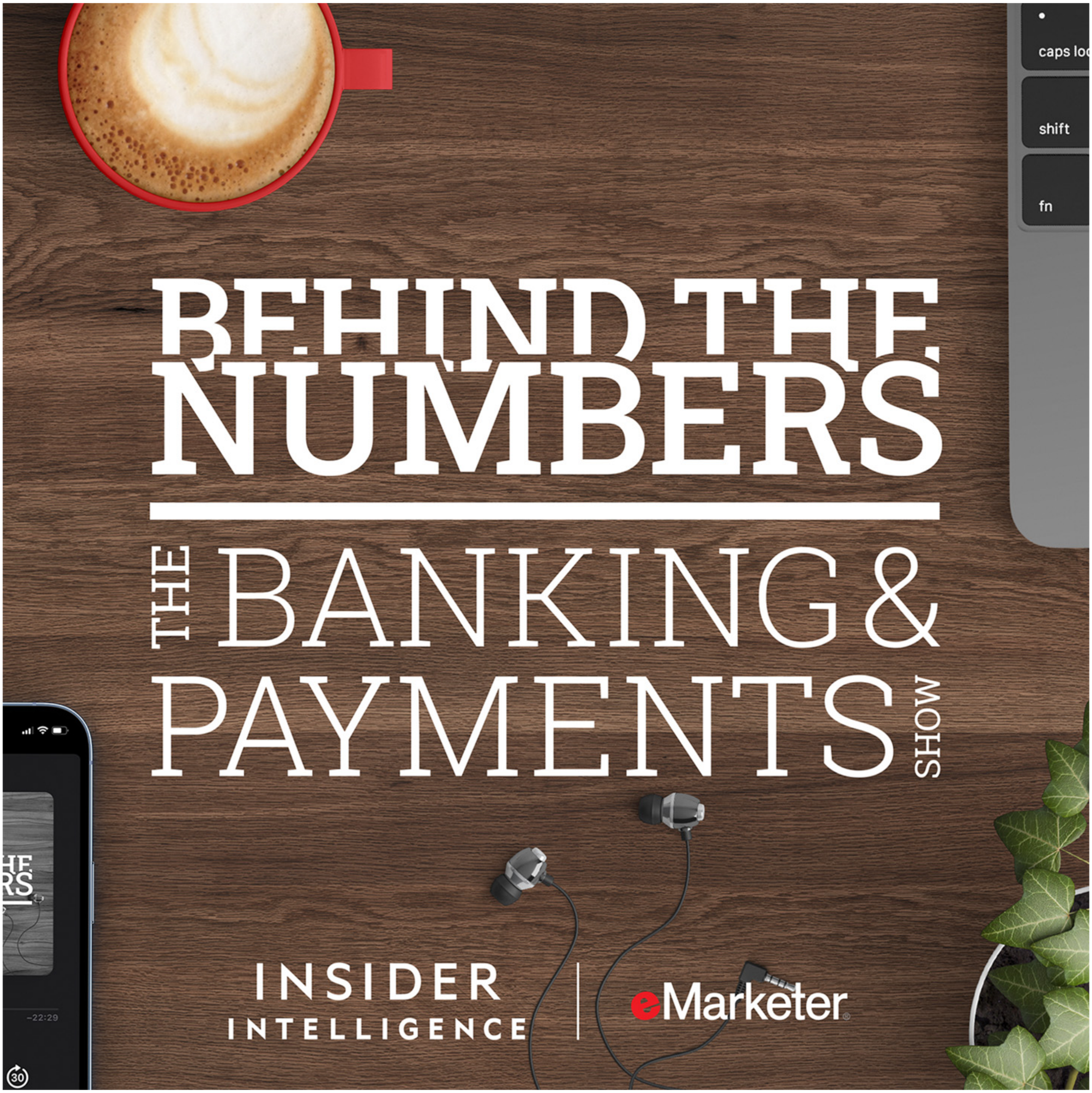
Rob Rubin, and Eleni Digalaki

The Banking & Payments Show: Fintech investment trends 2023

Audio

On today's episode, we discuss the fintech investment trends of 2023. In our “Headlines” segment, we look into why 2022’s fintech investments were lower compared to 2021. In “Story By Numbers,” we question the lack of mega deals in 2022 and consider what they may look like this year. And in “For Argument’s Sake,” we focus on future investment strategies in terms of disruption. Tune in to the conversation between our host Rob Rubin, analyst Eleni Digalaki, and Alex Sion, managing director of Motive Create at Motive Partners.



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Episode Transcript:

Rob Rubin:

Hello and welcome to the Banking and Payment Show. A Behind the Numbers podcast from eMarketer. Today is March 7th. I'm Rob Rubin GM of Financial Services here at Insider Intelligence and your host. If you enjoy this podcast, please give us a five star rating and subscribe. The title of today's episode is Fintech Investment Trends 2023. And I invited the head of Financial Services Research, Eleni Digalaki at Insider Intelligence. Hey Eleni.

Eleni Digalaki:

Hey Rob. Thanks for having me back.

Rob Rubin:

Yeah, I'm really excited. I also invited Alex Sion, Managing Director of Motive Partners. And someone that I worked with, a really long time ago, when he was at Moven. Hey Alex, how you doing?

Alex Sion:

Hey Rob, it's good to hear you again.

Rob Rubin:

Yeah, good to talk. I want to talk with you guys about the topic, so let's get right into the headlines. For today's episode, I'm drawing from CB Insights State of Fintech 2022 wrap-up. There's a slide that shows fintech investments are down 46% year-over-year in 2022 versus 2021. But, 2021 was a crazy year for fintech investments. And when you look at 2022 by quarter, it goes down, down, down. It doesn't look great. Q4 '22 had less investments than Q4 2018. Eleni, let me ask you, will fintech investments rebound in 2023?

Eleni Digalaki:

Yeah, thanks, Rob. I don't like making prognostications in fintech investing, but I think, at least for H1, the numbers will look similar to H2 last year. In terms of total investment, it will probably look subdued. But at the same time, funding last year was stronger than the numbers show if you only look at a quick glance, in my opinion, and I don't see that changing. For example, deals are still very much happening, but it's just that investors prefer backing smaller players, or placing smaller bets in big players because they got burned by some of the unicorns with the crazed valuations last year. Also, as valuations rationalize the sum of money you need to give to a company to get a 10% stake, is much smaller than what you needed to give at the end of 2021.

Obviously, those totals are going to look smaller. Then lastly, deals take longer to show, but it doesn't mean they're not happening. There's a lot more due diligence and the cycles are longer. At 2021, at some point, VCs would close deals in one day. This frenzy. That's not a thing and that's a good thing.

Rob Rubin:

That's incredible. Alex, if we zoom out from 2022 and we think about all these people that are closing deals in a day, has the composition of investors changed?

Alex Sion:

No, I think that's the thing I look a lot at Rob is the fact that what was driving the frenzy of the previous period. And a lot of it was new types of capital coming into the market that traditionally had not been focused on fintech. If you think about all the way to when fintech investing as a category began, it was really just traditional VCs that were going after the new players. Then as the phenomenon took hold, then you started to get in, obviously, the corporate VCs, every large financial institution launched a venture entity. That's a ton of capital come to the space. Then you got the private equity players, the sovereign funds. Fintech became all the rage. It just became this explosive amount of money going after a limited set of things that was still in a formation period.

Rob Rubin:

It flooded the market. But did that flood valuations, so a lot of the investments were really a little crazy?

Alex Sion:

100%. I think the supply demand was just way outbalanced. There's way too much capital looking for not enough things going out there. And I agree with everything Eleni was mentioning, that I think that's rationalizing now. I do think though that it's important to think about the thesis of every one of those investors in the game. I don't think the thesis has changed. I don't think anyone is saying that the fintech phenomenon is not a real place where value could be created. It's just now taking a deep breath and being smarter with the way that they're going about things.

Rob Rubin:

It used to be that when an investor said, "We need to see traction." They were talking about customer acquisition. A lot of the money that any B2C facing fintech spent was on customer acquisition. The question really is, have their priorities changed, particularly in later rounds? Are they more interested now in profitability and margin as opposed to customer growth? Have those priorities shifted?

Eleni Digalaki:

100%. Yeah. Both for investors and, obviously, the fintechs that they help.

Alex Sion:

Yeah, yeah, I would agree.

Rob Rubin:

But, the fintechs only changed because their investors told them to change. They were perfectly happy spending all that money.

Eleni Digalaki:

Yeah, to be fair to the fintechs, investors did tell them go chase users and give crazy perks for super costly acquisition costs. That was totally fine and encouraged. SI wouldn't put it on the fintechs.

Alex Sion:

I think there was a psychology going on there of the land grab. The new types of tech models that the freemium models, the ones that are based on build the audience and then the business model will come. It's tough to apply that to the fintech space. Then if anything was the lesson learned, I think that's the key one.

Rob Rubin:

I think the people that came are called regulators. I wonder how much that has to play in the calculus of investors now. What do you guys think?

Alex Sion:

I don't know. I think some of it, to be honest, was that there may have been a fundamental misunderstanding of the financial models within financial services from the world of Silicon Valley.A good example I'll use of that as the neobanking model, which I'm very familiar with because I lost to neobank, is the interchange model, just fundamentally, is a tough one to make viable. You can certainly drive growth in a marketplace, but you cannot drive a sustainable profitable business off of interchange unless you are Visa. Level scale.

Rob Rubin:

Right, the scale.

Alex Sion:

Exactly. It's just impossible. That was one of those things where I'm sure there was a plan B and C and D, but that was one of those that there's just foundationally was going to become a money sucker. It's too difficult to run that kind of model.

Rob Rubin:

But just to be fair, there are still neobanks who took the interchange play. But, that was a lesson that you learned a long time ago. Why wasn't that lesson learned and why didn't investors move on from that lesson?

Alex Sion:

I think there's always a hypothesis of engagement and probably some metrics that gave reasons to believe about the ability to move and evolve the model for modernization. And I don't doubt that I've seen personally some metrics that are eye-popping. But, certainly traditional banks have never been able to achieve this level of engagement. It's not easy to just pop up revenue streams in financial services. Maybe it gets back to where your regulator part, Rob. You just can't make up ways to make money. If you do, then you have a problem like we saw with Robinhood and maybe some of the others which is, yeah, you can invent ways to monetize, but there might burn you eventually.

Rob Rubin:

Right. I want to carry this conversation on. It's been a really interesting discussion about where investments are going and how sometimes the lessons that we learned a while ago, we forget a little bit in the exuberance of a market. I want to move to our next segment, Story By Numbers

In Story By Numbers, we pick a number or two that helps us dig deeper into the episode's topic. Today for Story By Numbers, I want to discuss another issue that is highlighted well in a slide in the CB Insight stack. The number of mega deals declined by 50% in 2022 versus 2021, 179 mega deals in 2022 versus 375 mega deals in 2021. My question is, why did the number of mega deal financing rounds decline in 2022? Was it just that they were the same companies getting financed, but the valuations were so much lower they fell out of the mega category?

Eleni Digalaki:

Yeah, I think part of it does go back to what we were talking about earlier. To give specific examples both Andreessen Horowitz and Tiger Global have said they're dialing down late stage investments because they've got burned. There's greater hesitancy among VCs to invest in mature fintechs. And it's tougher for those fintechs to raise large sums without a clear path to profitability. But, also it has to do with evaluations, what you just said. Rhe valuations today don't really support mega rounds. And lastly, I think that some of the late stage fintechs themselves don't want to raise money right now. Because they don't want to send a signal to the market of, "Oh, look, we've had a considerable down round." Some do. Some openly say, "I've cut my valuation internally," because they know they cannot grow into those valuations that they have. But, some don't and they don't want to send this signal to the market. They much rather try cutting efficiencies, making all the job cuts that we've been seeing, or even raising debt financing that wasn't so popular before then go to a VC.

Rob Rubin:

Surely, the founders and the early investors, if they can avoid a down round, they're going to want to do that.

Alex Sion:

Absolutely. I think there's only a couple of players that can essentially navigate those types of down rounds, like the Stripes of the world and things like that. And because they set the tone in many ways, I think Eleni is right. If the leading players are facing a more sober reality than for everybody else, it's just only magnified.

Rob Rubin:

What do you guys think that means moving forward?

Alex Sion:

I'm optimistic. Like I said, if I step back and I think from the lens of private equity and motive, which is fintech specialist stage agnostic, so we play across the board. There's a lot of opportunity. The thesis of disruption, I think to be honest, has been proved. It's not like it's not going to happen. It's not like customers don't want it. It's not like product-market fit wasn't proved. It's really about valuations in the business models. At that level, if you're a hands-on investor that can actually help portfolio companies create value and your favorable validations or valuations that are more sane, that's a good recipe for firms like Motive.

Rob Rubin:

That's great. Eleni, do you think that we're going to see an increase in investments? Are we going to see different kinds of players start making investments? I'm always wondering where the banks fall in terms of investing in fintechs.

Eleni Digalaki:

Yeah, I think I would expect more partnerships between banks and fintechs, largely because what we've been saying about valuations being more sane. But, also because fintechs are now much more open to that. I think MNAs will also go up. What was interesting in the CB Insight Tech was that only intra-tech MNA exits went up last year. I think we're going to see more sub-verticals increase the numbers of exits because of the valuations going down. The runways are starting to run out. And then many of the sub-sectors are quite crowded today. Banking as a service is an example. It's very hot, but also it's extremely crowded. I think that's an area where we'll see a lot of activity.

Alex Sion:

And building on what Eleni said, we are engaged at Motive with many large finance institutions, as you can imagine. The way I characterize the mood amongst those who are investing in innovation is that project work, not that appealing, but everybody's looking for deals. This investment of new stuff that they build themselves, they're more inclined now to seek out smart partnerships, smart things to buy rather than build. I do think that the winds are in the favor of fintechs from that perspective.

Rob Rubin:

When a bank is looking to make a fintech investment, how much of it are they thinking about, "This is a technology we want to deploy. Or we want to just make some money on this."

Alex Sion:

Much more the former than the latter. Like I said, every single financial institution launched a CVC to play in the game and to get a sense. Maybe it's a risk mitigation strategy against disruption. But at the end of the day, they're operating their own businesses with their own business model. The intent was always, "How do I use this technology to benefit myself?" I think that's become much more practical now because of just the nature of a little bit of the bubble being reduced. And to be honest, the advancements of the hard work banks have done to enable open architectures the ability to consume. Fintechs is much more sophisticated now. I think it's good trends.

Rob Rubin:

The thing about the big banks is they're just so big that, to a certain extent, all of the buzzing around them with these new things, it's like gnats. They're more annoying than anything else. But at the same time, some of the big banks have some real infrastructure problems in terms of creating an open banking API, for example. How much have the big banks, how much are they really going to be able to incorporate or are they moving more quickly towards that than we know?

Alex Sion:

I would say that the philosophy of what a fintech future represented versus closed models, proprietary enterprise versus cloud-based open, everybody's got religion on that. Across all sectors, they're at varying stages of evolution. But, I don't think anyone's pushing back on that vision anymore. Again, the major technology providers are even accelerating that shift.

That's a massive amount of money and transformation that needs to take place, which represents dollars. It's a massive shift. I do think that many fintechs will be able to make money if they just stick where the waves are going.

Rob Rubin:

This has been really fun to talk about mega deals and whether they're going to continue to decline or will they be level with 2022. I think we've decided they're going to be fairly level. The reasons why they're lower is because the money was crazy in 2021, the valuations were super high. And now that valuations are lower, there are also successful players that might not want to raise money at this time. There are many factors. I want us to get to our last segment, which I'm really excited about, For Argument's Sake. We look at two sides of an issue and, hopefully, argue nicely about it. But before we do, let's take a quick break to learn about Insider Intelligence's Pro Platform.

Over 100,000 subscribers at over 1000 companies use Insider Intelligence to keep ahead of the rapidly changing financial industry. Log on to Insider Intelligence's Research Platform to gain access to powerful reports, 1000s of charts, and our expert analysis and forecasts. Subscribers have access to exclusive perspectives from top industry leaders, valuable data sites, and industry specific trends to help them refine their strategies, target new audiences, identify new product opportunities, and improve the ROI of marketing activities. Head over to insiderintelligence.com to become a subscriber to access our research now.

Let's jump to our segment three, For Argument's Sake.

In our final segment, For Argument's Sake, I want to focus on different investment strategies. Many investors, as we've been talking about, they want to invest in disruption. Part of that comes with these founder geniuses who are leading the charge. It's not just VCs who get taken up by these geniuses. JP Morgan Chase invested $175 million in a startup called Frank, which was led by a 30-year-old entrepreneur named Charlie Javice. Chase is now suing Charlie for deception because, as it turns out, they didn't have as many customers as was stated, by a long mile. "But frankly," Joe contended, "maybe they were so enamored with getting a founder genius that they cut corners on their due diligence." Here's the thing, the value prop of Frank was disrupting the college financial aid industry. But, there are other types of investments that are more about optimizing or simplifying and maybe not as impactful as that unicorn successful disruptor.

For argument's sake, let's talk about future investments in terms of disruption, swinging for the fences and optimization, which is solid hits up the middle. Let's just start the discussion by me asking, will 2023 be good for more optimization types of investments? Or will we continue to see investors enamored with these founder geniuses who are trying to disrupt?

Eleni Digalaki:

That's a good question. I don't think fintechs can get away with having a great founding team today, especially the more mature ones. Example like yours, or most notably, some Sam Bankman-Fried and FTX have made investors much more cautious. But it's not just about the fact that they've been disillusioned by these founder geniuses, it's also that their priorities have changed. Today, VCs would probably much rather back a B2B fintech with a stable, predictable subscription revenue than a B2C fintech that's growing user numbers like crazy, but has no idea how to monetize them.

That's not something we were seeing as much before. Also, I know Alex said earlier, that no one is disputing the disruption narrative. But in many sub-verticals, there are too many players and this disruption narrative hasn't really played out in a meaningful way. The technology is there, the innovation is there, but the companies themselves cannot meaningfully penetrate their markets. I think we're going to say a lot of those fintechs themselves rethinking their business model and saying, "Maybe B2B2C makes more sense. Maybe I should be helping banks out or payments providers out rather than trying to disrupt them."

Alex Sion:

I would agree with that. I would agree with that. I'll caveat my statement of disruption is more the transformation versus disruption, because I think you're exactly right, Eleni. That the promise of the world turning over and then JP Morgan Chase and Wells Fargo Citi going away because the fintechs are taking them down. I think that is where there's a lot more of a sober view. But, the less sexy part of B2B2C or B2B, enterprise software certainly is an area where there's a lot of value to be created. Investors are getting that. The other thing I'd noticed, they've bet the table strategy that a lot of VC firms are forced into, where they're looking for the big disruptive players or the one monolithic player to take the entire market. As you get more diversified, investors playing. Not just traditional VCs betting the table, but the corporate VCs, the private equity firms, the family outlet, the ones who can take a longer term type of approach and less unicorn heavy, that impacts the way it'll play out, as well.

Rob Rubin:

Because a VC, they want an exit in eight to 10 years, right?

Alex Sion:

Just the nature of the model, the bets table, I've got to do a 1000 things in order for one thing to rise.

Rob Rubin:

They're looking for the hit?

Alex Sion:

Right.

Rob Rubin:

But, do you think that they're going to change? Because I feel like when they raise money for funds, that's what they sell.

Alex Sion:

Yeah, that model works. But, if you think about just the other capital at play that would be willing to look at different types of models and different ways to monetize. It will influence it. But, if you only have VCs fueling entrepreneurialism in this space, then every entrepreneur's incentive to tell a unicorn story, to pursue a unicorn path. That's a function of the capital. What is the capital looking for? I think they're now open to different things and realizing unicorns don't always work.

Rob Rubin:

Right. Isn't the founder someone that wants to start a business and go through that pain, Alex? They would like to make it big. They don't want to hear about, "I'm going to really help Wells Fargo optimize."

Alex Sion:

Yeah, I think a business is a business.

Rob Rubin:

Yeah. I do, too. But, I'm just wondering about the mindset of an entrepreneur.

Eleni Digalaki:

Yeah, I think even that is changing though a little bit because of all the problems many of the unicorns have had. Maybe an entrepreneur today wouldn't mind thinking, "I'm going to have a viable sustainable business that's around in 15 years and has a good product-market fit. I don't care if I'm not the next Claranor." We've seen what's happened with Claranor's valuation, but just as an example.

Alex Sion:

Yeah, I agree. That's where the frenzy comes into play. Not only was it at the investors pushing entrepreneurs, but the entrepreneurs focused on that goal. Then it became this self-fulfilling, not virtuous cycle, that pushed everybody into a bit of irrational territory.

Rob Rubin:

I think that we're right. Just because I've been around a while, I've seen the irrational exuberance turn into the reality. Then everybody say the lessons learned. Then over time we forget the lessons.

Eleni Digalaki:

Irrational.

Rob Rubin:

And we become irrational, again.

Alex Sion:

That goes back. Exactly.

Rob Rubin:

If I can just sum up this, I think it's fair to say that 2023 investments will look certainly more like 2022 than 2021. But, the types of investments might be changing towards more of those transformation and optimizing kinds of investments as opposed to completely all disruption. I think that we're also going to see other types of investors maybe take a larger role in fintech investments. Maybe the corporate VCs and other funds are going to start to play because it's a longer term play. Even though we've talked a lot about crypto on this podcast, crypto is like one of those long term plays, to me. That's not going to be a fast thing. That's going to require a lot of infrastructure, a lot of understanding, a lot to get that off the ground, that it's probably going to take a long time. Wow, that was so much fun. Thank you, Eleni. Thank you, Alex.

Eleni Digalaki:

Thanks for having us, Rob.

Alex Sion:

Thanks, Rob. It was great.

Rob Rubin:

Yeah, it was really a lot of fun. Thank you everyone for listening to the Banking and Payment Show, eMarketer podcast. Also thank you to our editor, Todd. In today's episode, we referenced data from CB Insights 2022 State of Fintech Report. Our next episode is on March 21st, and you'll not want to miss it. See you then.