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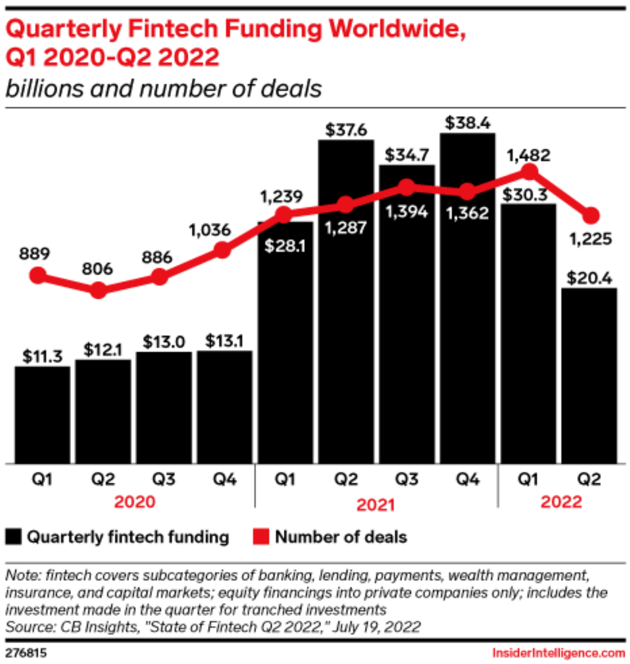
Analyst Take: Turbulent economy hurts fintech funding—here's how startups can act

Article

Fintech funding continued its downward spiral in the second quarter—and gave no indication of bottoming out. Fintechs must hunker down, trim fat from their operations, and refocus on their core value propositions.

In the short term, fintech funding has plunged—down 23% year over year (YoY) in the first half of 2022. Total fintech funding rests at $50.7 billion for H1, per CB Insights. A perfect storm of factors has cooled fintechs' funding frenzy, including steep inflation, rising interest rates, the war in Ukraine, and fears of a looming recession.



The longer view is more of a mixed bag. Funding for this year has already topped 2020's total. And VCs are building up their war chests: North American funds have added $88 billion in the first half of the year, nearly 70% of last year's total fundraising, per Refinitiv data cited by TechCrunch. But large fintech investors **Tiger Global** and **SoftBank** both recently signaled they will be slowing investments for the rest of the year, per TechCrunch.

It's unclear when the cash crunch will end. Public fintech performance since the start of the year has been dire: **Coinbase**, **Upstart**, and **Affirm**'s cumulative market capitalization has fallen by more than $70 billion this year through July 15. But "it can take over six months before we see what impact the public market downturn has had on venture funding," per **Andreessen Horowitz (a16z)** partners Justin Kahl and David George. And many VCs, including **Sequoia**, expect the stock market downturn could be long—unlike the steep V-shaped recovery during the first year of the pandemic.

The bigger problem is that funding is becoming more expensive. Fintech valuations have plummeted. Raising $100 million at a $1 billion valuation entails giving up 10% of a startup's ownership, but raising the same amount at a halved $500 million valuation requires giving up twice the equity (20%).

Our Take

Here's what funding and valuation drop-offs mean for fintechs and investors.

- **Funding will be even harder to get.** Investors are conducting more rigorous due diligence before investing in fintechs, which both lengthens deal cycles and reduces the odds of closing. Making matters worse, many funds invest in both public and private companies—and losing money in their public portfolios crimps their ability (and desire) to invest in private fintechs. Tiger Global's flagship fund, for example, lost 50% by June of this year.
- **And it will only stretch so far.** Record high inflation shortens startups' cash runways—how long until they run out of cash—by driving up expenses. This is why many fintechs are scrambling to cut costs: Since the beginning of 2022, fintechs have cut 14,750 jobs, per Layoffs.fyi's tracker.

How different fintech categories are getting hit

The funding crunch is hitting every fintech category, but each one feels the effects differently.

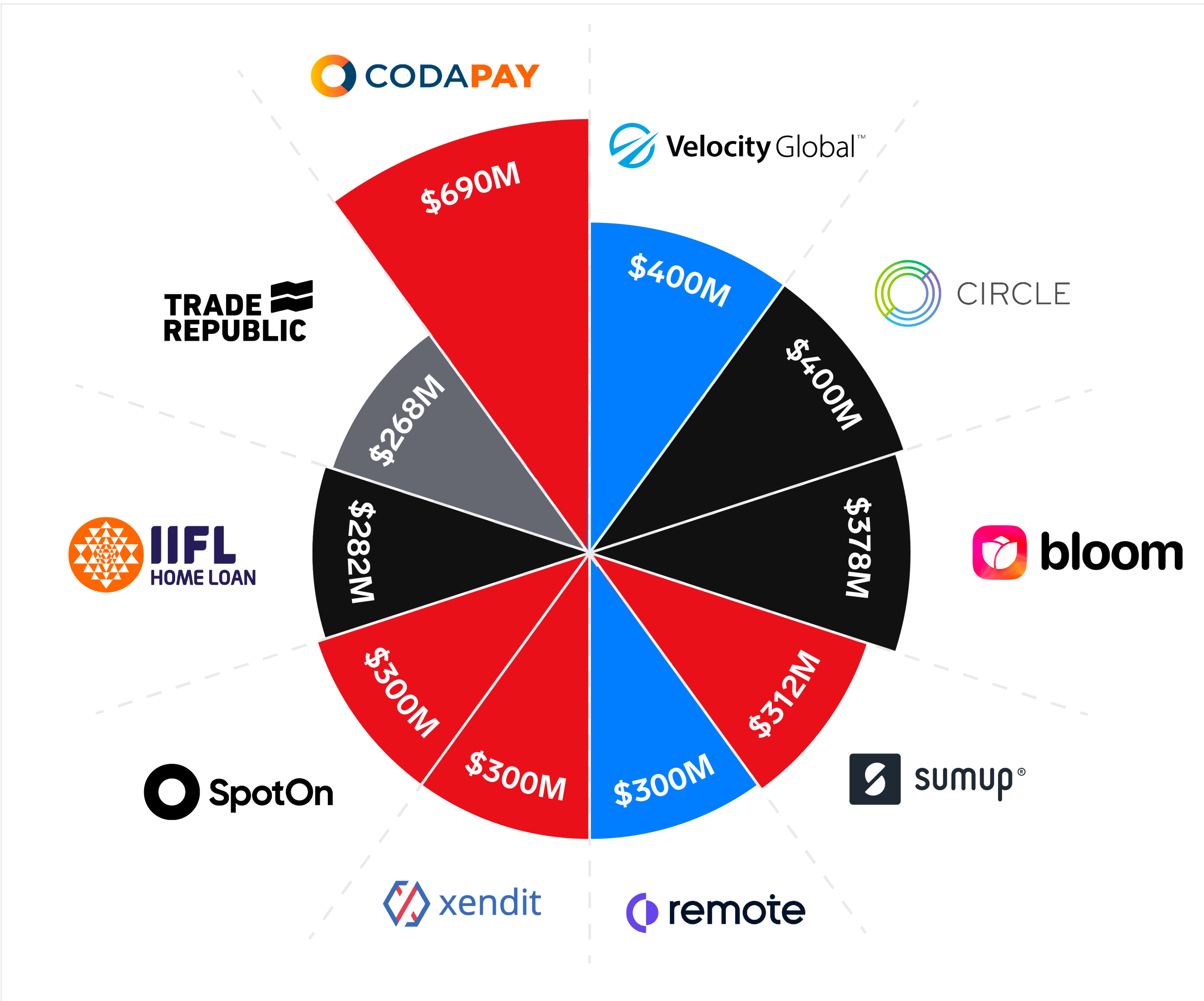
Neobank funding has disappeared. Funding to banking fintechs dropped 57% quarter over quarter (QoQ)—more than any other subsector broken down by CB Insights—and 77% YoY. The pullback from neobanks is partly explained by their inability to produce profits: Fewer than 5% are estimated to break even, per a report from Simon-Kucher & Partners.

Buy now, pay later (BNPL) providers are taking steep valuation cuts. Both public and private BNPL providers are taking hits. **Klarna** raised its latest round at a $6.7 billion valuation, an 85% drop from last year's high. Affirm's stock price had plunged 76% year to date by mid-July.

The crypto winter is putting the freeze on startup growth. The crypto market cap now stands at $1 trillion—compared with a record $3 trillion in November 2021. Plummeting crypto prices will test crypto startups—**BlockFi**, **Crypto.com**, **Gemini**, and **Coinbase** have all announced cost cuts—and limit investor appetite to back them.

Later-stage fintechs are finding it harder to lure in top investors and close megarounds. Both a16z and Tiger Global have dialed down late-stage investments, per CB Insights, while megaround funding fell 45% QoQ. Mature fintechs can no longer raise large sums without a clear path to profitability.

Top Fintech Funding Deals, Q2 2022



Payments
HR & Workforce Management
Accounting & Finance
Asset & Financial Managment & Trading

Source: CB Insights, 2022; Insider Intelligence
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Our Take

What should fintechs do?

Weathering the storm will require cost cuts, a singular focus on offering products that can bring in money, and securing good deals for external funding. Here's how fintechs should approach these priorities:

- **Trim fat.** Costly customer acquisition tactics like referral and sign-up bonuses should be among the first expenses to go; fintechs should focus on adding profitable new clients rather than growing at all costs. Downsizing offices and reducing office perks should be another priority: Many employees rated fancy "mandatory fun" perks like ping-pong tables and game consoles as the least wanted, per a recent Framery survey.
- **Preserve investments in product development and iteration** to offer services that consumers will want to pay for even after tightening their belts. For example, digital wallets should focus on rewards that resonate with cash-strapped consumers, like **Curve** letting consumers earn cash back on grocery shopping.
- **Reconsider expansion.** This should include geographic, product, and client segment strategies. Take **Brex**, which recently stopped servicing SMBs to focus on startups, its core customers. Co-CEO Henrique Dubugras told CNBC: "We got to a situation where we realized that if we didn't choose one, we would do a poor job for both."
- **Seek funding at the right time.** On the one hand, allowing time to improve business fundamentals before seeking funds will lead to better valuations. On the other, funding could keep getting scarcer, and fintechs nearing the end of their runway will get worse deal terms. Sequoia advises having at least a 12-month runway when seeking funds.
- **Choose carefully between VC funding and debt financing.** The former might lead to a considerable down round, which can also hurt brand strength, but the latter is becoming increasingly expensive as interest rates rise. When **Freetrade** raised £30 million ($41.3 million) through a loan agreement, CEO Adam Dodds said that "to zero in on a valuation at this point is maybe not that helpful," per the FT.

***Read more:** A series of our reports delve into the short- and long-term changes we see amid market turbulence for neobanks, BNPL providers, stablecoins and cryptos, and insurtechs. You can access them here:*

- Neobanks Confront Uncertainty: How Challengers Can Create a Lifeline as Funding Dries Up
- The Era of Uncertainty: Buy Now, Pay Later—What Short-Term Challenges and Long-Term Changes Mean for Providers and Retailers Right Now
- The Era of Uncertainty: Stablecoins—How Stablecoin's Crash Will Shape Crypto's Path
- The Era of Uncertainty: Insurance—How Insurers Can Turn Gathering Headwinds Into Opportunities