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Jul 27, 2021 • 38 tweets • fintechjunkie/status/1420061176361279489

For 10+ years, fintech startups were in “IPO or bust” mode because there weren’t many active buyers in the ecosystem.

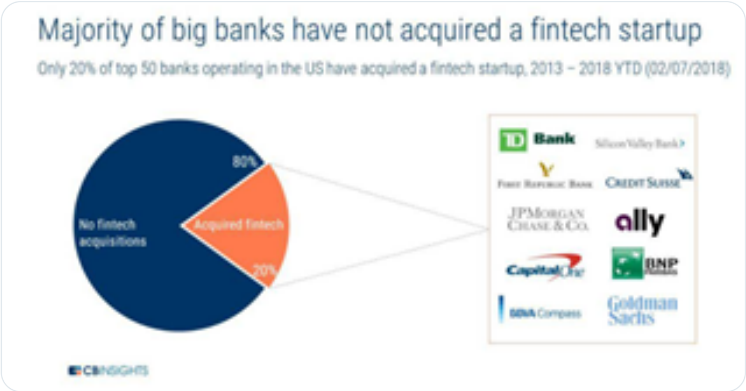
But buyers are back which has profound implications on the outcome distribution for Founders and VCs. This is DEFINITELY worth internalizing. Unpacked:

2/38: Until a few years ago, fintech startups were considered “niche opportunities” with very limited upside. Today, 1 in 5 investment dollars are chasing startups in this “niche” ecosystem and it seems like a day doesn’t go by without another fintech unicorn being minted.

3/38: But, for more than a decade, fintechs have been shaking up the traditional banking sector with their disruptive models. Fintechs have assembled low-cost modern tech stacks with modern UX/UIs and paired flexible infrastructure with an intense focus on their customers’ needs.

4/38: Traditional banks bring very different skills and assets to the table. They’re suffering from tech debt due to products built on top of legacy infrastructure but have scale and the machinery to navigate the complexities of operating in a highly regulated industry.

5/38: But banks have been slow to buy fintech startups even though it makes sense on paper. In fact, in the first decade of "fintech" (2009-2018), acquisition activity was anemic with around two dozen transactions by the "majors". Most banks didn't participate at all.



6/38: Explaining why banks "sat it out" is easy.

Lofty multiples, short-term optimization, build vs. buy thinking and integration challenges.

These issues stem from insular thinking and management prioritizing what analysts and investors want vs. what their customers want.

7/38: Lofty Multiples

Since 2008, fintechs convinced VC and PE firms that they were more "tech" than "fin" and therefore deserved tech multiples. These same firms prioritized growth over profitability and valued companies based on future metrics.

8/38: During this period, banks were trading in the public markets based on trailing P/E multiples of 10-20X and fintechs were trading in the private markets at forward revenue multiples of 5-15X. The divide was seen as too wide to cross.

9/38: Short-Term Optimization

For great fintechs, the value of their brands, customer bases, growth machines and proprietary technology stacks are coveted by banks. But, banks have historically struggled to attribute significant value to these intangibles.

10/38: How much a bank has historically been willing to pay for an asset has always focused on answering the question: "How long will it take for the acquisition to be accretive"? Banks don't like when the answer is unclear or is many years in the future.

11/38: Build vs. Buy Thinking

Big companies have by definition been successful (otherwise they never would have become big companies). If not checked, this success can create hubris and a “not built here” culture.

12/38: Most banks have fallen into this trap. Many Bank Executives believe that it would be cheaper and easier to build than to buy. But the truth is that most Banks are terrible at shipping code. Shipping code is everything and Banks haven’t historically done it well.

13/38: Innovation is brought to life in code and code is like trying to study the stars. Looking at a star 50 light years away means looking 50 years in the past. To ship code 1 year after having an idea means addressing a problem that’s 1 year old from a market perspective.

14/38: And if fintech companies are shipping code in weeks vs. months or quarters vs. years at a traditional Bank, the fintechs are better able to keep up with the "now" needs of the marketplace vs. its "yesterday" needs.

15/38: Integration Challenges

Big, well-run banks are well oiled machines. They run smoothly based on the cultural norms and decision processes they’ve built over time. The people fintechs hire and how they get work done is extraordinarily different!

16/38: Banks have set up systems where most decision makers aren’t rewarded for pushing the envelope but they are punished if they go too far. It’s a system with zero upside and unlimited downside (getting fired).

17/38: Contrast this to a fintech where getting to “no” is equivalent to shutting their doors. It has to string together enough “yes” answers over a multi-year period to earn the right to survive. Yes means finding a way that works EVERY SINGLE DAY.

18/38: So banks have wanted more of what fintechs bring to the table but they’ve been reluctant to adopt the methodologies of the nimble, problem-solving-orientation of successful fintechs. The fear on both sides of an acquisition has been that “integration” would kill the magic.

19/38: But the tide is changing. More banks have started to acquire fintechs. A handful of fintechs have become large enough to buy smaller fintechs. And non-bank tech companies are entering the fray because they plan on adding fintech capabilities to their product suites.

20/38: Driver 1: Technicals have improved

Tailwinds for banks include the wave of one of the best economic recoveries in U.S. history, with consumer spending aided by massive amounts of liquidity and low interest rates. Bank stock prices are up and closing in on 2X book value.

21/38: Banks' balance sheets are also much larger with deposits surging from an unprecedented period of consumer saving and loan paydown. JPM is a good example having gained $1T in deposits in the past year. But while deposits are important, they need to be put to work.

22/38: Driver 2: Capital and Growth

There's only so much capital banks can return to shareholders because of CCAR. But they're generating a lot of capital and their stocks are trading at healthy valuations which makes acquisitions easier to execute that in the past.

23/38: The last wave of regulatory implementation is complete (Dodd-Frank, etc) and no new regulations are on the horizon to worry about. The last administration took the shackles off growth so banks like JPM decided to expand into all states because it finally could.

24/38: Regionals can continue to grow through bank M&A but the biggest banks can't. On a relative basis, fintechs are more expensive acquisition targets but the public markets clearly believe there's value to be captured (Tradeweb, Square, Stripe, Affirm,

)

25/38: Driver 3: Internal innovation efforts

Banks have tried to innovate with marginal success because they don't have the talent, processes or speed to take on nimble startups. Playing "catch-up" is difficult when the landscape of fintech offerings is constantly expanding.

26/38: Certain pieces of banking are starting to exhibit winner-take-most dynamics. In spaces like payments and investments, being a fast follower or a me-too player isn't good enough. Building to a world class standard is more difficult than buying an emerging winner.

27/38: Driver 4: Emerging Winners

Most public companies allow "the street to lead the witness". They carefully manage industry analysts and optimize for quarterly earnings reports. In the past, this meant worrying about goodwill and insisting that acquisitions were accretive.

28/38: The public markets are rewarding tech-forward banks because the impressive performance of platforms like Square and Paypal has upped the perceived value of owning market leading offerings. But buying established winners is expensive so banks are looking earlier.

29/38: Banks have finally started to internalize that market momentum is real. A company that's growing at a 100%+ growth rate isn't going to suddenly slow down. Paying up for these companies while they're small is cheaper than waiting for them to double and double again.

30/38: This strategy adds goodwill to an acquirer's balance sheet but the market has been rewarding acquirers for being "technologically forward". And to Founders, it creates an off-ramp that puts tens of millions of dollars in their pockets and de-risks the rest of their lives.

31/38: Bonus Driver 1: Fintechs Are Buying Fintechs

There are now a few dozen fintechs (private and public) with enough scale, capital and capabilities to buy smaller fintechs. These acquisitions are "threat enhancers" to an already threatened bank ecosystem.

32/38: Pre-IPO fintechs are buying smaller fintechs to dress up their IPO narratives. Acquisitions can diversify a company's revenue base and tell a story about how it has significant growth potential because secondary product lines have additional TAM to chase.

33/38: Bonus Driver 2: Tech Companies Are Buying Fintechs

Many tech companies have sizeable, highly engaged user bases and are masters at upselling. There's a reason why the best tech companies (especially SaaS) are able to predictably grow revenue/customer year-over-year.

34/38: Adding fintech products to a tech company's offerings can result in 1 plus 1 actually equaling 3. Their highly engaged users are often receptive to buying bundled or integrated products and cheap distribution and servicing is transformative to the economic equation.

35/38: In the tech world, B2B acquisitions are generally easier than B2C acquisitions. In the B2B world, feature completeness and the value of built-in distribution is easy to understand. It's harder to jam B2C companies together for various reasons.

36/38: The result

What's become increasingly clear is that "selling to a strategic buyer" has become another exit option for Founders and Investors. Adding exit options theoretically increases the expected value of the distribution of outcomes.

37/38: If too many startups choose to exercise this option then value will shift from Investors and Founders to Strategics. But if the absolute best-of-the-best startups stick it out then Investors and Founders might be better off due to shorter duration and re-risked outcomes.

38/38: TL;DR: Banks cannot grow without innovating and internal innovation efforts aren't getting the job done. The fintech ecosystem is where innovation is happening and it's now big enough to threaten banks and impossible to ignore. The net result is that buyers are back!!!

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