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Detour: An altered path to profit for European fintechs

To navigate the economic fall-out from COVID-19, Europe's fintechs will need to adjust their playbook.

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Fintechs have been on a roll. Fueled by generous amounts of venture capital funding, last year 24 financial services startups hit a valuation of more than $1 billion, bringing the global total of such highly valued “unicorns” to 58. Together, these and other fintechs have ushered in a revolution in customer experience: Consumers can now open an account or get a loan in a matter of minutes (instead of weeks or months), exchange and send money internationally at low or no fees, and buy products with instantly created no-interest installment plans. Fintechs have also upped the ante for speed and agility, launching new features and initiatives in weeks instead of the six- to twelve-month timeframes more typical of banks.

The emergence and spread of COVID-19—in the first place a world health crisis—is also causing unprecedented economic damage across the globe. Most McKinsey COVID-19 scenarios show European economies contracting by 11 percent in 2020 and not returning to pre-crisis levels until 2023. Fintechs are already feeling the squeeze. Venture capital funding has slowed, business model vulnerabilities are being exposed, and competitive dynamics are shifting. This has brought the sector’s underlying profitability and long-term business model sustainability into sharp focus—to a point where we believe the path to profitable scale for many fintechs has been structurally altered.

This is not at all to write off the sector. Fintechs have several long-term advantages—they are native to the digital arena, with more efficient cost structures, organizational agility, and, most importantly, higher customer loyalty. Consumers are now accustomed to quick, easy, low-cost financial transactions, and we believe there is no going back. In this article, we explore how the dynamics for fintechs have changed (particularly in Europe), the opportunities and implications for financial services incumbents, and how fintechs can weather the storm.

An altered path to profitable scale

“It is only when the tide goes out that you discover who’s been swimming naked.”
– Warren Buffet

Fintech funding has slowed, and scarcity may be with us for a while

In a matter of weeks, venture capital funding for fintech companies went from surplus to scarcity. After growing more than 25 percent a year since 2014, investment into the sector dropped by 11 percent globally and 30 percent in Europe in the first half of 2020, compared to the same period in 2019.[1] In July 2020, after months of COVID-19-related lockdowns in most European countries, the drop was even steeper—18 percent globally and 44 percent in Europe, versus the previous year (Exhibit 1).

This constitutes a significant challenge for fintechs, many of which are still not profitable and have a continuous need for capital as they complete their innovation cycle: attracting new customers, refining propositions and ultimately monetizing their scale to turn a profit. The COVID-19 crisis has in effect shortened the runway for many fintechs, posing an existential threat to the sector.

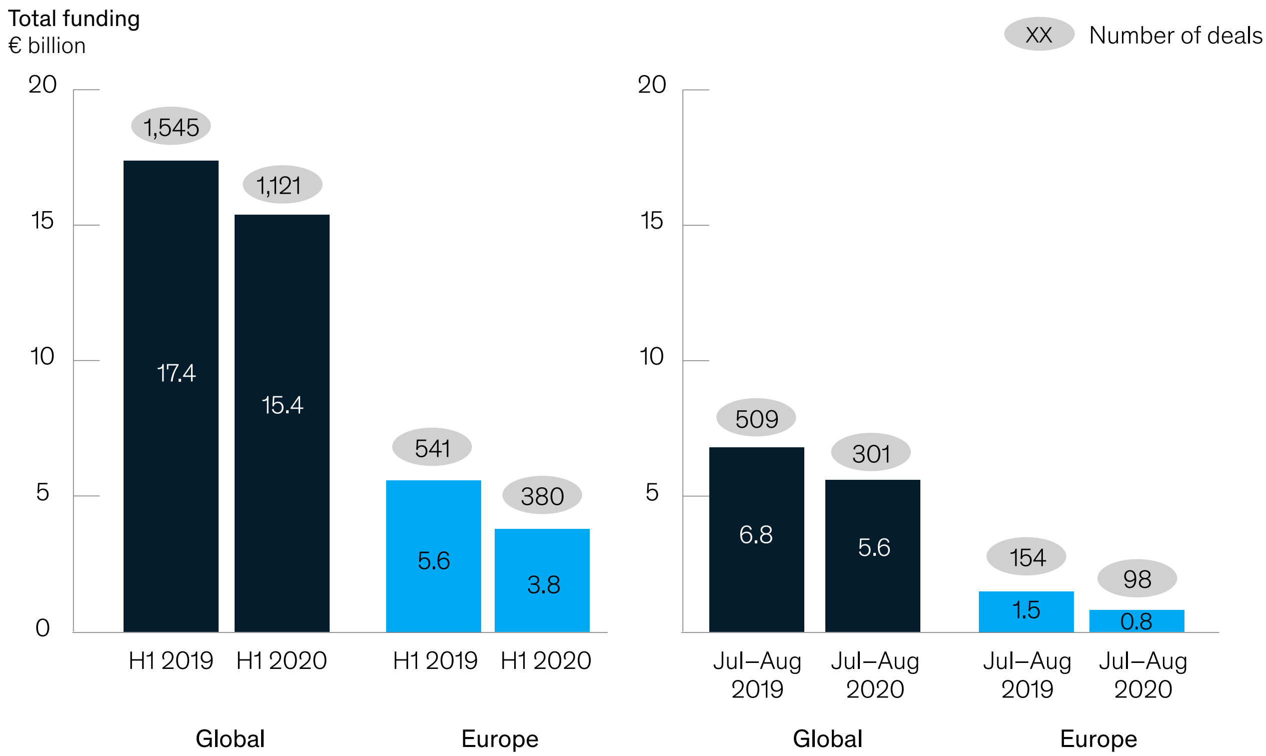
Analyzing fundraising data for the last three years from Dealroom.co, we found that as much as €5.7 billion will be needed to sustain the EU fintech sector through the second half of 2021 (Exhibit 2)—a point at which some sort of economic normalcy might begin to emerge. It is not clear where these funds will come from. Fintechs are largely unable to access loan bailout schemes due to their pre-profit status. In addition, government-backed wage support/furlough packages have income caps well below the typical salaries of fintech engineers and other skilled talent, which represent a large proportion of the fixed costs of these businesses. While the VC and growth investment community will continue to

[1] Dealroom.co data as of September 4, 2020.

Exhibit 1

Fintech funding has declined both in Europe and globally.

Global venture capital fintech funding and number of deals in H1 2019/2020 and Jul–Aug 2019/2020



Source: Dealroom.co

back some companies, they cannot meet the aggregate demand on their own. European governments have stepped in to help, but they too are only a stopgap. For instance, the UK created a coronavirus Future Fund to invest in growth sectors of the economy, of which £320 million has been dispersed to fintechs through a convertible loan that matches funds raised from venture investors. Germany and France have also launched similar funds.

Some fintechs are in the enviable position of having recently raised money or reached profitability, and thus may be better able to withstand a funding disruption. For others, we see three likely funding effects emerging:

1. At-scale fintechs and some sub-sectors gaining disproportionately;

2. general downward pressure on valuations (it's a buyers market); and

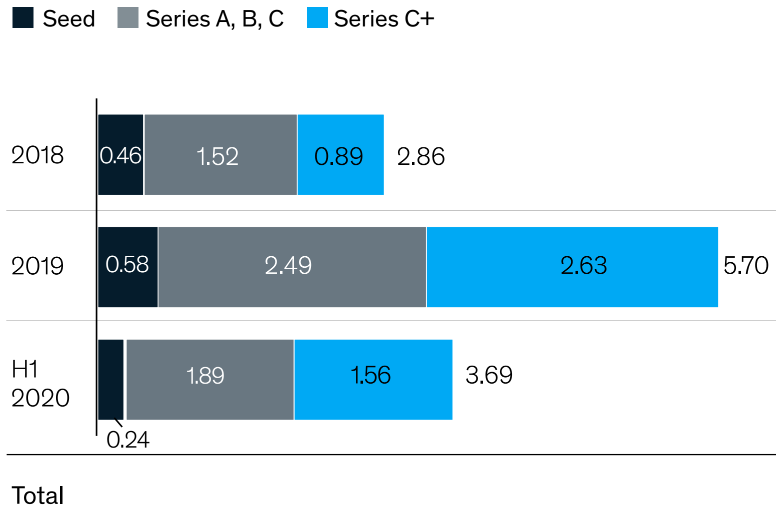
3. increased relevance of incumbent/corporate investors.

Sub-sectors such as digital investments, digital payments, and regtech, which have had tailwinds from crisis-related changes in behavior, appear set to take a greater share of the funding pie. For example, US-based retail trading app Robinhood raised $200 million in August 2020, increasing its valuation

Exhibit 2

As much as €5.7 billion will be needed to sustain European fintech through 2021.

Distribution of fintech funding by year,[1] € billion



Estimated funding needed through 2021[2]

	Seed	Series A, B, C	Series C+	Total
2018	0.5	1.5	0.9	2.9
2019	0.3	1.2	1.3	2.9
H1 2020	-	-	-	-
Total	0.8	2.8	2.2	5.7

[1]Funding last raised in respective years 2018, 2019, 2020.
[2]Numbers may not sum due to rounding.
Source: Dealroom.co, data as of September 4, 2020

from $8.6 billion in July 2020 to $11.2 billion. In addition, there appears to be a surge in corporate and incumbent activity. For example, American Express recently acquired US-based Kabbage, a fintech that offers credit and cashflow management solutions to SMEs.

Business model vulnerabilities

Although fintechs offer a different customer value proposition than incumbent banks, they are still subject to the same economics as the broader banking sector. The COVID-19 pandemic is expected to have a significant negative impact on overall industry profitability (Exhibit 3). As household incomes decline and discretionary spending drops, European transaction volumes and value could decrease by 10 percent for domestic transactions and 25 percent for cross-border transactions. Loan volumes are also under pressure as the broader economy slows down. As a result, Western European retail banking revenues after risk could drop by 35 to 40 percent as risk costs rise (by 4-6 times) and net interest margins decline due to persistent low interest rates.[2]

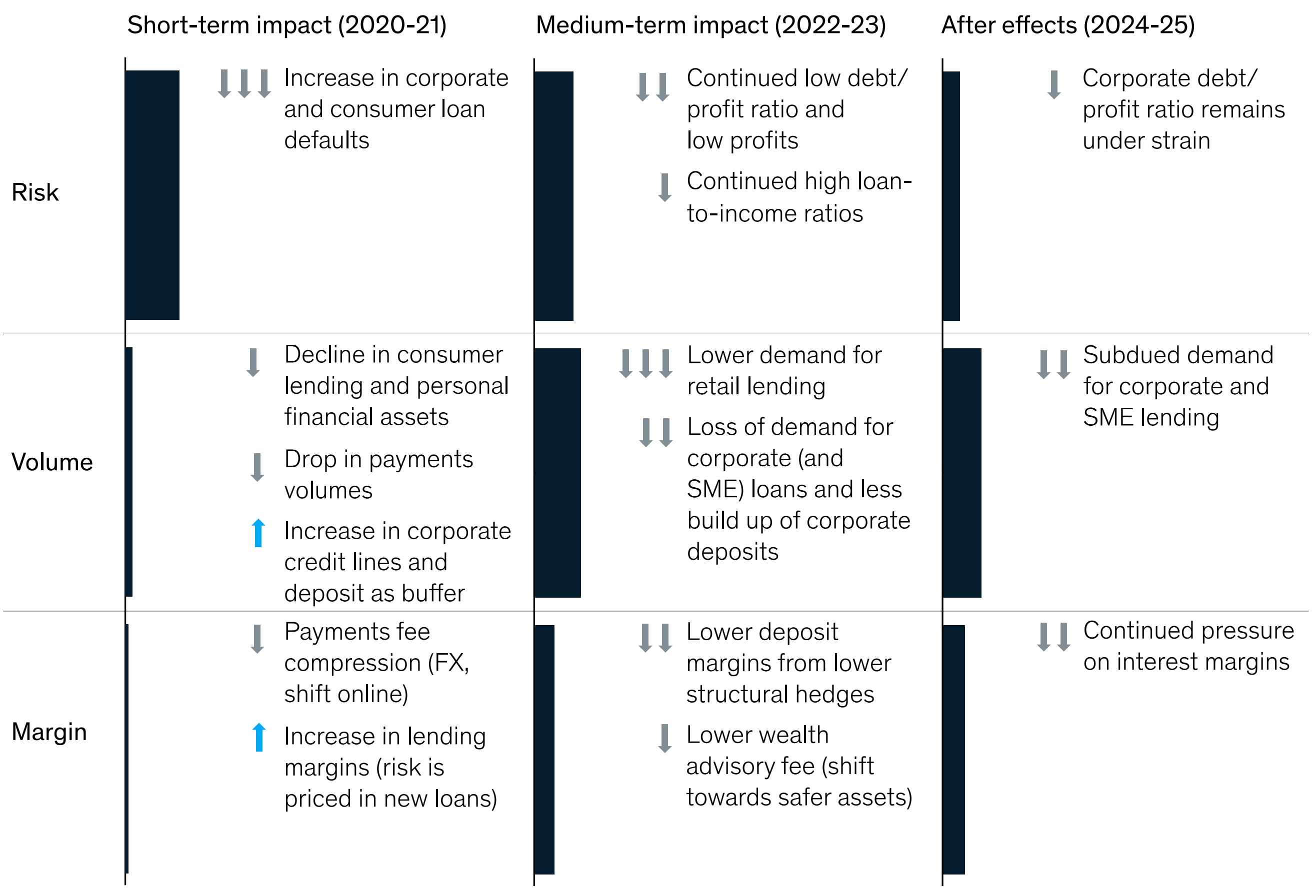
Take digital banks as an example. Even before the COVID-19 crisis, their challenges in getting to profitable scale were non-trivial. On average, customers at digital banks hold 1.5 products, as compared to 5 for traditional banks, according to a 2018 McKinsey survey.[3] In addition, digital banks rely on transaction fees and commissions for the bulk of their revenues, and only a few have been successful in having customers sign up for a subscription/account fee. Incumbent banks, on the other hand, generate income from multiple sources beyond transaction fees—including

[2]Based on the A1 scenario introduced in "Safeguarding our lives and our livelihoods: The imperative of our time," McKinsey & Company, March 2020, McKinsey.com. Numbers updated as of April 23, 2020.
[3]McKinsey Open Banking Survey; figures include individual products (e.g., multiple credit cards and savings accounts).

Exhibit 3

Fintechs will not be immune to the negative impact of COVID-19 on banking.

‘Lost’ revenue[1] between ‘muted recovery’ (A1)[2] scenario from pre-COVID-19 forecasts;[3]
sum of Germany, UK, France, Italy, and Spain, 2020–25

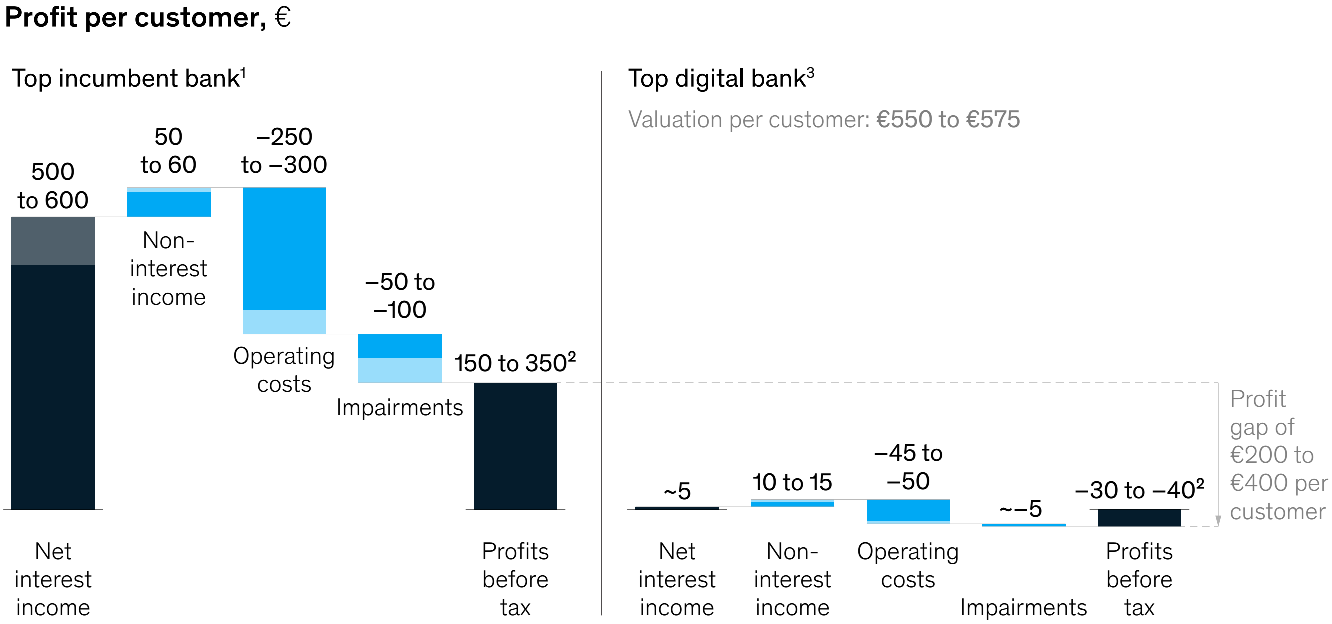


[1]Retail and corporate banking revenues; does not include capital markets revenues.
[2]"Safeguarding our lives and our livelihoods: The imperative of our time," McKinsey.com, March 23, 2020.
[3]Comparison of the decline in revenues vis-à-vis pre-COVID-19 forecasts (2023 pre-COVID-19 forecasts less 2023 forecasts under “muted recovery” scenario)
Source: MGI; McKinsey PFIC – Global Banking Pools

packaged accounts, commercial and consumer credit products, mortgages, and investments. As a result, many digital banks have a cash-consumptive business model that requires continual investor funding. Pre-COVID-19, their loss per customer was between €10 and €60. (Top-performing incumbent banks, on the other hand, generated €150 to €350 per customer) (Exhibit 4). Now, fintechs’ loss per customer is expected to expand to €20 to €75 (and profit per customer at top incumbent banks to drop to €50–€200). Fintechs that are skewed towards customer acquisition (as opposed to driving positive unit economics) are particularly challenged. Given the contracted funding environment, many digital banks cannot sustain a cash consumptive business model in the medium term. Instead, a laser-sharp focus on expanding their revenue engines, coupled with a shift in customer acquisition strategy to pursue more economically viable segments, will be required.

Exhibit 4

Pre-COVID-19: European digital banks faced challenges compared to incumbent banks.



[1]Based on average economics of top Western European incumbent banks' retail banking segment for FY2019.
[2]Numbers may not sum due to rounding.
[3]Based on average economics of top Western European digital banks available pre-COVID-19.
Source: McKinsey research and analysis

The pandemic has also severely impacted monoline businesses such as peer-to-peer (P2P) lending and marketplace financing. These businesses match borrowers and lenders, earning the difference between the interest charged to borrowers and the funds returned to the lender. Until the first quarter of this year, these companies relied on cheap funding, a surplus of low-credit-risk borrowers, and highly automated operations to make their economics work. Higher post-COVID-19 credit risk (a four- to six-fold increase) now requires the recalibration of underwriting standards and the build-out of collections capabilities. Many P2P platforms, required by regulation to grant COVID-19 payment holidays to borrowers, have had to reduce their interest payouts in order to increase the amount of their "loss absorbing" funds. For instance, in May 2020 it was reported that 6 percent of borrowers at UK-based RateSetter (recently acquired by UK challenger bank, Metro for up to £12 million, pending approval) requested a payment freeze, causing the company to halve its interest payouts (from 3 to 4 percent to 1.5 to 2 percent) and increase the size of its Provision Fund (which serves as a buffer to cover missed payments from borrowers). In the long term, the resilience of this business model will depend heavily on how the sector adapts its risk management practices and addresses its funding challenges. In particular, many of these companies will have to navigate conduct and compliance issues through what will be their first real experience of a negative credit cycle.

Finally, B2B fintechs, which sell services and technology to financial institutions, are grappling with increasingly challenging selling environments. Now more wary of upfront costs and multi-year commitments that won't pay off quickly, 40 percent of large financial institutions said they are conducting a more detailed ROI analysis before making purchase decisions. Fintechs that help financial institutions rapidly digitize, automate, and reduce their costs are the most likely to continue to get attention and win sales. Those providing end-customer capabilities, such as dashboards and visualization components, may now be viewed as a “nice to have” purchase for financial institutions.

Changing competitive landscape

Today’s new economics are likely to prompt a wave of consolidation. With fintechs at lower valuations, incumbent banks and other corporate players have a rare opportunity to enter new areas or gain access to proven talent and technology. For example, JPMorgan partnered with Taulia, a California fintech, to develop customized trading solutions for customers. Making these fintech/incumbent unions work can be notoriously difficult—superior execution will be critical.

Acquisitions are also likely to occur amongst fintechs. Many already leverage each other’s capabilities (for example, many fintechs use other fintechs like OnFido and Jumio to support KYC diligence), but we see potential for even more ambitious combinations. Synergetic fintechs could merge to quickly fill monetization gaps in their business models. A fintech with a large transactional customer base but no lending capability, for instance, might acquire credit expertise and the relevant technology in order to offer a broader customer value proposition.

At-scale and mature fintechs will get the biggest benefit, as competitors consolidate, weaken, or simply go out of business. The current environment offers a window for successful and profitable fintechs to supplant competitors with targeted offers and competitive pricing at a time when customers are more likely to be open to alternatives. These companies are also likely to continue to attract capital.

Adjusting the playbook: Four actions to consider

“You’ve got to know when to hold ’em, know when to fold ’em, know when to walk away, know when to run.”

– Kenny Rogers

The demand for quick, easy, low-cost financial transactions isn’t going away. If anything, the crisis-fueled shift to digital channels is accelerating the demand—and fintechs may be in a better position than incumbents to respond. Between 5 and 20 percent of consumers in Western Europe say they expect to do more digital banking. As many as 80 percent of consumers in these markets say they prefer to handle everyday financial transactions, such as checking balances and money transfers, digitally. This is true even for consumers in the over-65 age segment.[4]

The issue is not *whether* fintechs persist, but rather *which* will survive. We have identified four emerging imperatives that all stakeholders in the sector—from fintechs and investors to incumbent banks and corporate partners—should pay attention to.

1. Targeted retrenchment combined with big bets

With core economics challenged and capital sparse, it is obvious that many fintechs will have to retrench thoughtfully if they want to avoid burning money unsustainably and spending themselves out of business. This will mean trimming international expansion plans, business lines, products, and initiatives. Fintechs have to focus their energies and capital on areas where they can truly make a difference—and do so quickly. Importantly, this entails not just cutting back, but also placing bigger bets and directing leadership attention to areas with long-term potential. London-based Revolut, for example, in addition to

[4] McKinsey Financial Decision Maker Pulse Survey; run in early April 2020; countries surveyed include UK, France, Italy, Spain, Germany and Sweden (1,000 representative consumers each).

taking steps to adjust its cost base has also indicated it is looking at inorganic options in the travel space.

2. Leaning into next-normal behaviors
The ability to rapidly respond to changing customer needs is one of the hallmarks of the fintech industry. COVID-19 has brought digital payments, digital onboarding and virtual customer service to the forefront. Players now need to take a hard look at their value propositions and roadmaps and ensure that they reflect evolving customer behaviors and segments, testing and validating new propositions at pace. For some fintechs, this will mean helping governments meet the unprecedented demand to provide fiscal relief to citizens and to distribute these funds appropriately and quickly. In the UK, OakNorth, Starling, and Funding Circle, among other fintechs, pivoted quickly to become approved lenders for the Coronavirus Interruption Loan Scheme. In Italy, payments providers Soldo and Satispay were the only fintechs selected by the City of Milan as preferred channels for distributing government aid to people who qualify.

B2B fintechs also have an opportunity to meet new needs. OakNorth, a lender for small and medium-sized companies, sold its platform to two large US banks to help them analyze and monitor the impact COVID-19 is having on individual loans and to automate the customer journey for small businesses applying for and receiving Paycheck Protection Program loans.

There is also an opportunity for B2C companies to expand into B2B markets. UK-based OpenWrks's spinoff Tully launched a payment relief portal that allows consumers to claim bill payment suspensions from more than 50 UK banks, credit card companies, building societies, and energy companies. Digital banks might also consider white-labelling their technology platforms and digital capabilities for incumbent banks that are in dire need of rapid digitization. With so many of their employees working remotely, financial institutions have a greater need for paperless customer verification and enhanced KYC technology, which will allow them to digitally onboard new customers without increasing their anti-money laundering risk exposure.

3. Business model course corrections
The potent combination of changing customer buying and consumption patterns, a weaker economy, lower interest rates, and reduced creditworthiness represents a fundamental challenge to many fintechs' business models. Company leaders need to take a hard look at their economic model and make adjustments, while preserving the best aspects.

For instance, digital banks still have the advantage of no physical footprint, flexible, modular technology, and an agile operating model. We estimate that these business model advantages coupled with robust monetization strategies can yield a net incremental pre-tax profit of €60 to €100 per customer, which would be in line with current valuation per customer (Exhibit 5). Our analysis shows that about 50 percent of this incremental value will likely come from credit-related propositions, with a further roughly 30 percent from thoughtful introduction of subscriptions and product fees. As an example, UK digital bank Monzo launched its "Plus" account at £5 a month, offering customers interest, no fees on international ATM withdrawals, and a dashboard view of other bank accounts and credit cards.

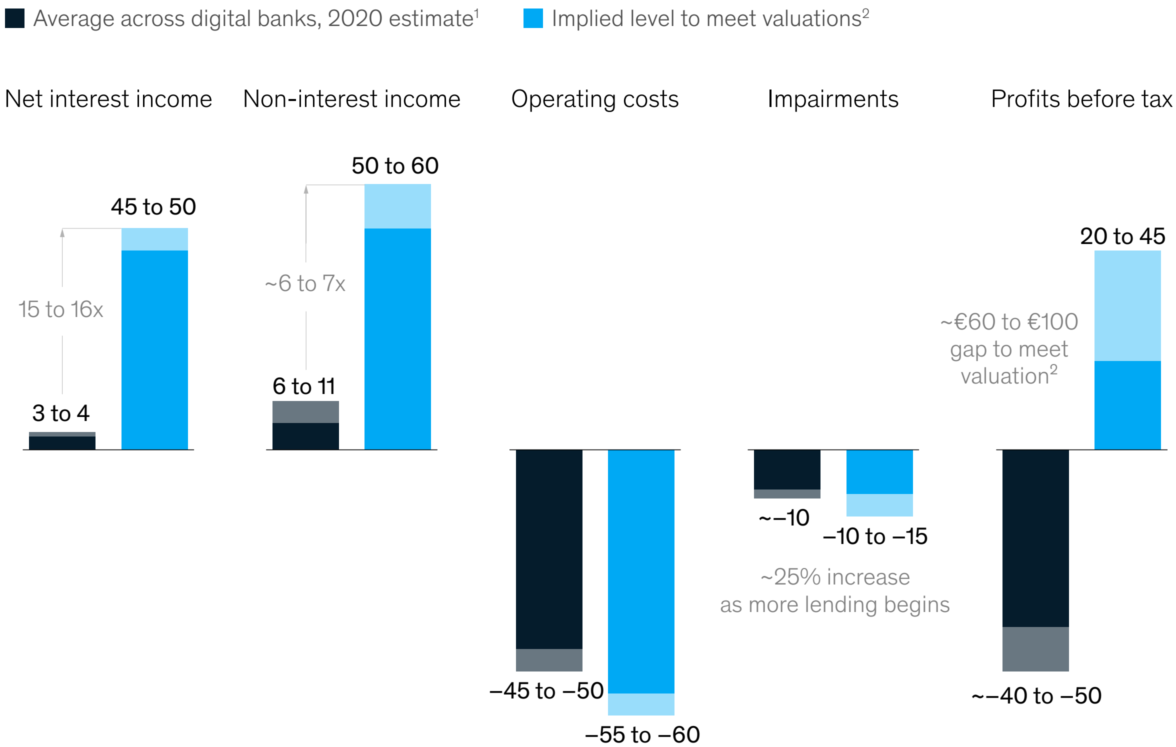
B2B fintechs, which are contending with longer sales cycles and more cost-conscious buyers, would do well to revisit their pricing structure. Given the relatively fixed nature of their costs, offering customers a product trial approach with lower upfront costs and considering shifting from their current license-based pricing model to a usage-based one could unlock opportunities without damaging long-term economics.

4. Fueling growth through M&A and joint ventures
Many of the key actions fintechs want to take—such as launching new features, building new capabilities, or pivoting toward new revenue streams and segments—could be achieved

Exhibit 5

Digital banks need to increase profit per customer by €60 to €100 to achieve valuation comparable to industry.

Profit per customer at top digital banks, €



[1]COVID-19 impact estimated based on McKinsey A1 ("muted recovery"); adjusted for H1 2020 results of major banks.
[2]Profit estimated based on digital banks reaching a P/E ratio between 10x (avg. WE banking multiple as of August 2020) and 20x. NII and other income have been proportioned according to Scandinavian banks (NII: 45%; other income: 55%). Based on current valuation of €400 to €450 per customer.
Source: Company reports, Press, Panorama Global Banking Pools, McKinsey Analysis

more rapidly through thoughtful acquisition or partnerships than by organic development. Three areas stand out as likely to see higher activity: next-generation credit capabilities, open data, and distribution collaboration.

The pandemic has upended many manual credit processes and credit-scoring models, creating a need for new approaches. Many incumbents/ corporates are turning to fintechs to meet this challenge. Lending marketplace FundingXchange, together with credit bureau Experian, launched a B2B service to help lenders assess whether SMEs meet lending criteria for different loan types. As previously mentioned, the UK's Metro Bank is in the process of acquiring marketplace lender RateSetter, in an effort to bring RateSetter's technology, talent, and skills quickly to its customers. Fintechs, particularly those that are centered around transactional products, would do well to look at such routes to accelerate their credit capabilities.

With the advancement of open banking/PSD2, the use of open data to help customers and institutions make better financial decisions will grow. For instance, the ability to overlay COVID-19 scenarios at the borrower P&L line-item level to predict expenditure, or drive early-warning systems using real-time transaction data from open banking, will be valuable capabilities. Mastercard, for example, is in the process of acquiring data aggregator Finicity, which uses consumers' financial data to help banks speed up credit decisions and improve account verification processes. Visa's acquisition of Plaid, whose API software lets third parties like Venmo connect to users' bank accounts, allows Visa to expand beyond its core payments business. Given that such data capabilities are likely to become table stakes in the future, securing relevant assets should be a priority now.

If executed successfully, partnering with or acquiring players with complementary or adjacent propositions serving the same end customer is almost always advantageous. Distribution synergies and/or proposition expansion can cost-effectively increase value per customer and loyalty. We believe the current crisis has opened up new opportunities for the acquisition/partnership approach. For instance, Tide, a UK-based digital bank, teamed up with insurance solutions provider Hokodo to launch a new invoice-protection product for SMEs. During the UK's lockdown, Swedish mobile POS manufacturer iZettle partnered with last-mile delivery company Stuart to offer a remote payment and courier service to small businesses without an ecommerce presence, allowing these businesses to sell digitally.

Embracing the new reality with pace and agility

"In the new world, it is not the big fish that eats the small fish, it is the fast fish that eats the slow fish."
– Klaus Schwab

Fintechs have had an undeniably positive effect on the range of financial products available and have ushered in a new sense of possibility for the industry. As is often the case with innovations, the original creators may not persist but their new ways of doing things often do. As more incumbents struggle to adapt, the winners will be those that quickly recognize the changed context and that are most capable of responding with clear decisions and bold actions.

Many organizations, both incumbents and start-ups, have adapted with surprising quickness and rapid decision making through the COVID-19 crisis. This new sense of possibility and potential should inform future action. Whilst there will undoubtedly be challenging times ahead, speed and a willingness to challenge orthodoxies are necessary to thrive. Fintech companies have shown great potential for transformative impact—now is the time to fulfill that promise.

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