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LOMBARD ODIER

INVESTMENT MANAGERS

FinTech positioning for a re-opening in 2021

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At a glance

- The pandemic has accelerated many of the secular growth trends within FinTech and has also helped to increase the digitalisation of the broader economy.
- Over the course of the year, lower interest rates, in combination with a scarcity of companies growing their earnings, have led to a sharp re-rating of growth stocks. Valuations in the space, especially for the hyper- growth-oriented business models, have reached extreme levels in several cases.
- This extreme environment calls for very selective stock picking amongst these high expectation stocks. Within the FinTech strategy we avoid most of these "revenue growth at any price" stocks and prefer high quality compounders.
- Democrats taking control of the Senate, House and White House could result in additional economic stimulus. We think it is likely that this will lead to increased inflation, and an end to decreasing interest rates that have been with us for the past decades.
- Vaccines are key in 2021. With positive vaccination development towards the end of the year, stimulus support can be lowered again. That will be the time where we can clearly differentiate between companies again.
- Within the quality framework of our investment process, we have re-positioned the portfolio in order to benefit from a re-opening scenario and from a more pro-cyclical Biden administration. We select reasonably priced profitable quality compounders with a high purity factor that benefit from long-term FinTech trends.

COVID has accelerated long-term FinTech trends.

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This extreme environment calls for very selective stock picking.

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Executive summary

The pandemic has accelerated many of the secular growth trends within FinTech and has helped to increase the digitalisation of the broader economy. In recent whitepapers, we have focused on these accelerating trends within FinTech. In the first whitepaper, "Tokenisation: Revolution or Evolution?" we explained how the asset management industry would be impacted by asset tokenisation, which we consider to lead to the democratisation of investments. This creates winners and losers and despite it being too early to clearly point out who the winners will be, it is possible to invest in those that enable this trend to unfold in the coming years.

In "China leading the move to a digital currency," we explain how the world is rapidly moving towards a fully cashless society, urged on by governments and health organisations to avoid the use of paper money during the crisis. This structural shift has been further boosted by China leading the way with the introduction of a Central Bank Digital Currency (CBDC) with many central banks following their example as a response to the rapid decline in cash and as an answer to the rise of private market initiatives like Facebook's[1] Diem and the tremendous popularity of crypto currencies.

In our last whitepaper, "Digitalisation in the financial sector" we elaborated on how digitalisation has transformed the thinking of financial service companies from something which is nice to have, into a must-have. We believe that the long-term strategic rationale for digital is shifting: 2020 is a year of cost cutting, 2021 is a year of re-aligning and prioritising IT projects, followed by many years of transformative digitalisation.

As a result, 2020 has been the year in which many of the companies which either have a strong digital offering or the ones that enable the digitalisation of the financial sector and broader economy have performed very well. Consequently, valuations for the digital winners, especially the hyper revenue growth business models have become very high. Within our investment process we select reasonably priced profitable quality compounders with a high purity factor that benefit from long-term FinTech trends. Given the strong valuation discount to the hyper-growth companies, we expect to see a rotation into these more attractively-valued compounders. Furthermore, towards the end of last year we have added cyclical upside to the portfolio within the opportunity set of our proprietary FinTech universe. This in order to benefit from a sharp vaccine-led economic bounce back in 2021. An (even) more expansionary fiscal policy by the new US administration could trigger even more rotation.

The most interesting cyclical areas within our universe can be found within payments, more credit exposed personal finance FinTechs, online brokers and payrolling companies. We avoid BigTech as they do not meet our purity hurdles and we stay away from unprofitable hyper-growth business models.

[1] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

COVID has accelerated long-term FinTech trends

Our FinTech strategy is based on five core beliefs. Together these beliefs provide our top-down starting point for finding bottom-up companies that stand to benefit most. Our core beliefs are:

1. The world will move towards a fully cashless society.
2. Digital finance aids financial inclusion.
3. Digitalisation lowers barriers to entry, improves efficiency and enables new financial services.
4. The rise of technology ecosystems.
5. Cyber security as a basic necessity for all digital financial services.

For all of these beliefs, we see secular growth has accelerated due to pandemic. For example within digital payments, according to MoffettNathanson, there is tangible evidence of a step-up in cash displacement which could add 5-7ppts to payment volume growth in 2020, while 2021 could even become the strongest year for payment volume growth in a decade. Card penetration is expected to jump by 3.2ppt in 2021 (compared to 2-2.5ppt on average between 2012 and 2019), as the accelerated deployment of payment continues and the pandemic “pulls forward” digital payment penetration by 12-18 months.

Financial inclusion is at the core of many of these FinTech’s strategies as their low cost technology helps to incorporate many of those left behind into the financial system. Through cash apps much of the stimulus money has been able to reach people and small businesses that went into survival mode during the worst of the pandemic.

Digitalisation in financial services has taken an ever more prominent role over the last decade. With competitive pressures having increased, financial companies that had always invested in their digital solutions – or those that are digital by nature – found themselves to be on the winning side. Again these companies were the ones benefitting most from the sudden spike in demand for digital services as a result of the global pandemic. Within the financial sector, banking services are relatively furthest along in terms of digitalisation, followed by insurance companies and the asset management industry respectively.

The re-bundling effect is observable within financial services, and with that, the dominance of large technology ecosystems (super-apps) has grown. Big Tech entered financial services in order to keep their client base engaged. Since financial services are not their core activity, they form a competitive threat to pure-play companies. On the other hand, they also form opportunities for FinTech enablers who white-label their solutions to these Big-Tech players.

Cybersecurity software has always been high on the agenda in terms of IT budget allocation. It is a necessity because of the continuous attacks, but also because of the regulatory consequences for losing data. COVID has created an additional level of uncertainty when it comes to cybersecurity. IT security effectiveness has decreased, time to respond has increased and the focus of cybercrime has shifted to remote work. This toxic mix has resulted in a spike in the number of cybersecurity attacks during the first six month after the first pandemic wave. Attacks against the financial sector increased 238% from the beginning of February to the end of April (S&P market intelligence, 2020).

Hyper growth companies valuations getting stretched, focus on growth at a reasonable price

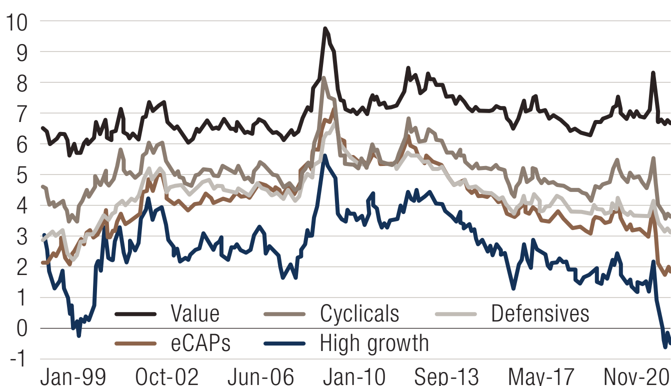
Over the course of the year, lower interest rates in combination with a scarcity of companies growing their earnings have led to a sharp re-rating of growth stocks. Valuations in the space, especially for the hyper- growth-oriented business models have reached extreme levels in several cases. Growth stocks have been among the clearest beneficiaries of the low interest rate regime, given their long duration, leading the style to significantly outperform the market compared to all other factors. As can be seen in the next chart from Credit Suisse HOLT, the drop in their discount rate has clearly gone hand in hand with falling interest rates. Significant downside risk exists for these hyper growth stocks if interest rates move sharply higher or they under-deliver on the high embedded growth expectations.

FIG. 1 HOLT DISCOUNT RATE OF TOP QUINTILE GROWTH STOCKS (ALL CAP, GLOBAL MARKETS) VERSUS 10-YEAR TREASURY RATES

Source: Credit Suisse HOLT, November 2020.

The outperformance has been so pronounced that the valuation of high growth stocks is now beyond dotcom levels, as measured by the median market-implied discount rate. In fact, the market has moved to work with negative implied discount rates for many of the hyper-growth stocks in the US in order to justify their valuations, and implied discount rates globally are starting to become much more differentiated. The US, for example, has many negative implied discount rate companies, while Japanese companies are trading at their highest implied discount rates in many decades. There are also big sector differences. Within Information technology we find low (or negative) implied discount rates, while within the financials sector the implied discount rates are more in line with their historic average. Another phenomenon resulting from these exuberant market conditions is the sharp rise in Special Purpose Acquisition Companies (SPACS). These are "blank cheque" shell corporations, designed to take companies public without having to go through the traditional IPO process. The main issue is that investors need to fully trust management to, first, find a good target company to acquire and, secondly, pay a decent price for it. It is a gamble with only one winner; those who receive the very hefty fees. The SPAC market ballooned in 2020 and we see more than 70 SPACs lined up to be listed in the first quarter of 2021. So this story will continue and the impact on our FinTech universe will become more noticeable. Clear fundamental analysis and valuation work is impossible to perform on most M&A announcements and most of the companies choosing to come to market via SPACS are unprofitable and looking for a quick way to receive funding in order to fuel their need for growth. When the money machine stops, there is no organic way of funding growth.

FIG. 2 HOLT DISCOUNT RATES 1999-PRESENT FOR VARIOUS STYLE BUCKETS



Source: Credit Suisse HOLT, November 2020.

This extreme environment calls for very selective stock picking amongst these high expectation stocks rather than purely chasing the momentum. Within the FinTech strategy we avoid most of these "revenue growth at any price" stocks and prefer high quality compounders as reflected by the eCaps in HOLT methodology. These are cash flow return on investment (CFROI) compounders with high barriers to entry that have delivered solid track records of value creation. But besides CFROI, we also select those with low dependency on external financing, solid excess economic return generation and good ESG integration, in accordance with the Lombard Odier IM investment process. As a result, their relative valuations are significantly more attractive, with the added benefit that they have lower sensitivity to higher interest rates and their cash flow streams are more predictable.

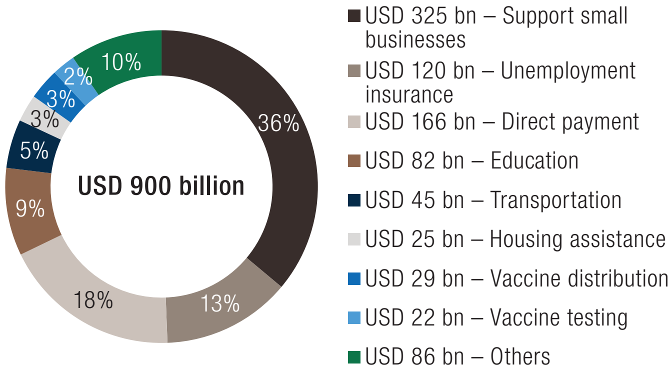
Re-opening and Biden impact on Financials/ stimulus/BigTech/macro/rates

With Democrats taking control of the Senate, House and White House, the way for Biden to implement his agenda has eased. This could result in additional economic stimulus, including the expansion of payments to individuals with profound economic effects, as can be seen in the figure below. We think it is likely that this will lead to increased inflation, and an end to decreasing interest rates that have been with us for the past decades. Increasing interest rates would be very beneficial for the financials exposure in our portfolio, as well as e-brokers. There is also a positive secondary effect in the sense that higher interest rates are likely going to lead to increased profitability within the broader financials sector, hence more money available to engage in large IT overhauls. This would be clearly beneficial to our software providers and those companies that enable traditional financial companies to make the required IT updates to remain relevant and compete with new FinTech initiatives and big-Tech companies offering financial services via partnerships.

While the timeline for vaccination rollouts has proven underwhelming and despite resurfacing lockdowns, our baseline scenario is a sharp vaccine-led economic bounce back in 2021 with pre-COVID levels of output reached in the second half of this year. We see large differences between regions, however. This needs to be considered in terms of portfolio positioning, where we most likely see the fastest recovery in China, followed by the US and Europe respectively.

FIG. 3A DECEMBER BREAKDOWN OF PACKAGE PASSED

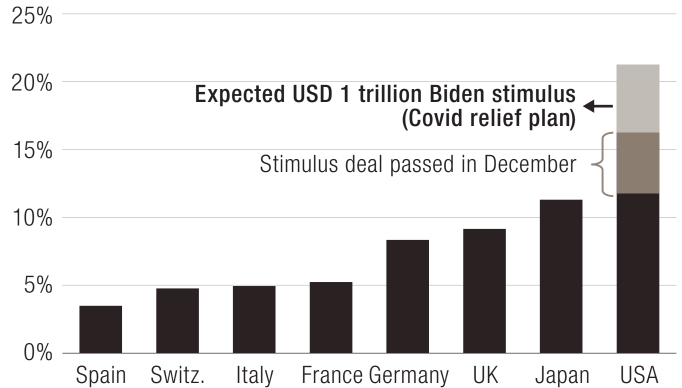
COST ESTIMATE BY CATEGORY (IN USD BILLIONS)



Future additional measures?
USD 2000 checks, state & local government aid, enhanced UI renewal.

FIG. 3B US FISCAL RESPONSE TO COVID-19 CRISIS: A VAST SCALE

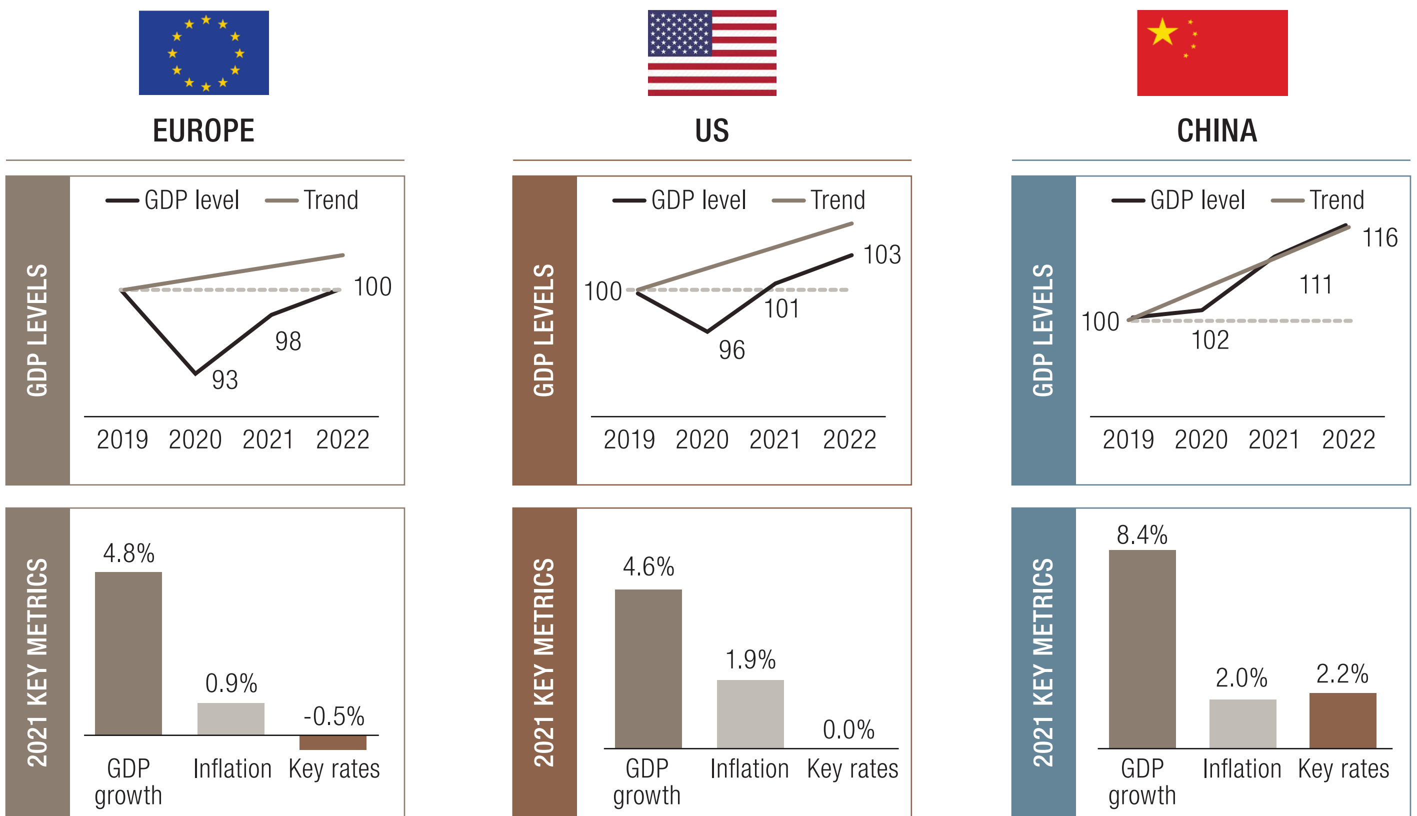
GOVERNMENT SPENDING INCREASE AND TAX REDUCTIONS IN 2020 (IN PERCENT OF GDP)



Source: Bloomberg, IMF, Lombard Odier, 2021.

FIG. 4 BASELINE SCENARIO: A SHARP VACCINE-LED ECONOMIC BOUNCEBACK IN 2021

PRE-COVID LEVEL OF OUTPUT REACHED IN Q3 2021 IN THE US & Q1 2022 IN EURO AREA



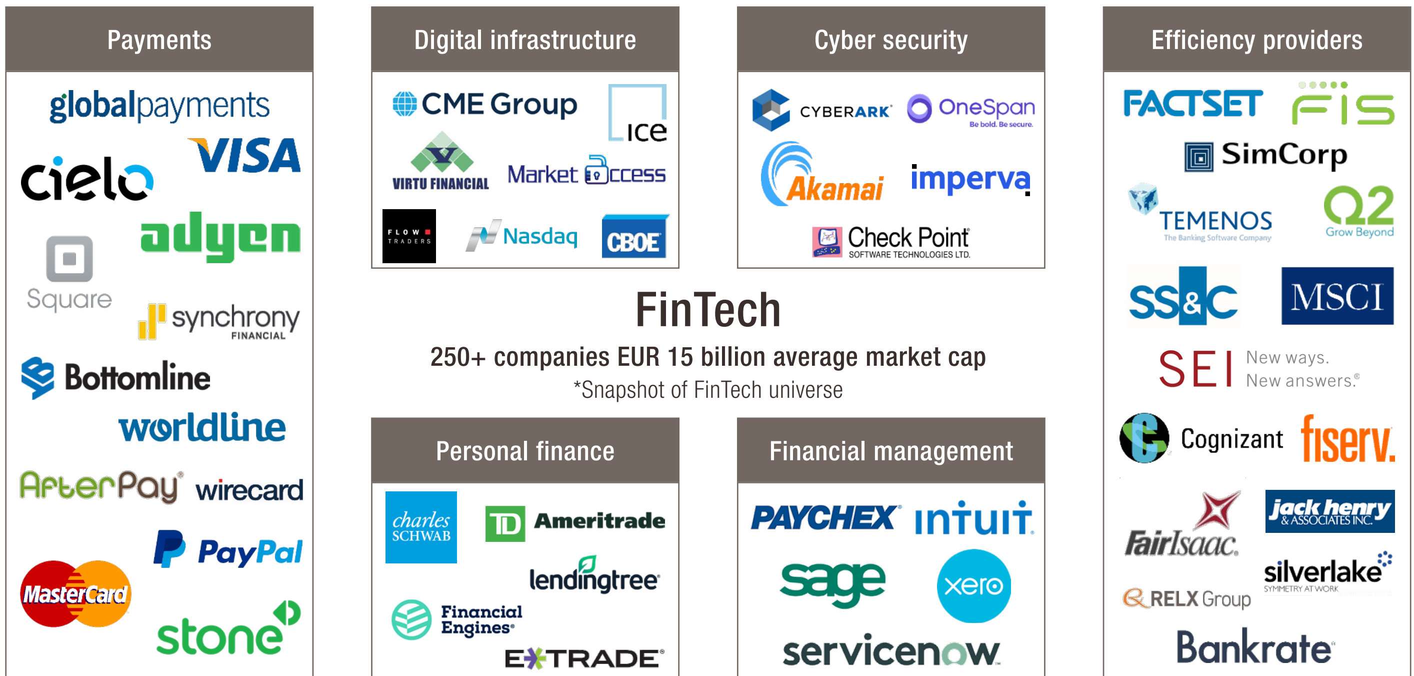
Source: Lombard Odier, 2021.

Vaccines are key in 2021. With positive vaccination development towards the end of the year, stimulus support can be lowered again. That will be the time where we can clearly differentiate between companies again. Those who have sustainable business models will survive and those who are dependent on markets and funding rounds to continue their hyper-growth phase with a promise of profitability somewhere in the near future will find it much harder to attract new investments.

How to benefit from the rotation?

For our FinTech strategy, we have identified more than 250 companies that benefit from the digitalisation of the financial sector. A snapshot of this universe is listed below. We perform a quality overlay on top of this universe to select the best business models and financial track records. Without exception, all of members of our proprietary FinTech universe benefit from increased digitalisation.

FIG. 5 FINTECH UNIVERSE OF OPPORTUNITIES AND THERE IS A EUR 18 BILLION MARKET CAP



Source: Lombard Odier, 2020.

Within the quality framework of our investment process, we have re-positioned the portfolio in order to benefit from a re-opening scenario and from a more pro-cyclical Biden administration. Out of our current top ten holdings, nine companies are direct beneficiaries from an acceleration in the global economy. The sweet spot of a combination of structural and cyclical growth can be found within digital payments. Within this category, the most cyclical exposed investment areas are corporate, travel and tourism. Beneficiaries are companies like WEX, Fleetcor and Visa. Payment companies like Adyen, PayPal or Square,[2] on the other hand, will continue to benefit from the secular shift towards online but less so from a re-opening scenario. Overall, close to one third of the portfolio is exposed to payments. Other beneficiaries can be found within the personal finance/consumer finance space where companies not only benefit from structural partnerships with FinTechs but offer cyclical upside from lower credit losses, higher interest rates and a recovery in loan demand. Online brokers benefit from higher interest rates as well, given the large number of client assets yielding close to zero. Of the portfolio, around 10% is invested in personal finance. Another part of the portfolio is invested in high quality payrolling companies, which also benefit from re-opening economies. Given our high FinTech purity hurdle we avoid BigTech that, because of high valuation, regulatory scrutiny and interest sensitivity, could become a source of funding for the rotation towards more cyclical stocks.

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Conclusion

The pandemic has accelerated many of the secular growth trends within FinTech and as well as helped to increase the digitalisation of the broader economy. As a result, 2020 has been the year in which many of the companies which either have a strong digital offering, or the ones that enable the digitalisation of our economy, have performed very well. As a result, valuations for the digital winners, especially the hyper revenue growth business models have become extreme. Within our investment process, we select reasonably priced profitable quality compounders with a high purity factor that benefit from long-term FinTech trends. Given the strong valuation discount to the hyper-growth companies we expect to see a rotation into these more attractively valued compounders. We have added cyclical upside to the portfolio by selecting FinTech companies that are benefitting from the reopening of our locked-down society.

[i] MoffettNathanson, Payments: The Pandemic Rattles the Foundation of the Bull Thesis – Our New 5-Year Industry Forecast, July 2020.

[ii] HOLT Global Viewpoint, November 2020.

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