

Future returns

Fintech has changed finance forever. What comes next?

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Q2 2023

In the Q2 issue of *Future returns*, our quarterly report on thematic and trends in equity markets, we explore how fintech has altered the financial services industry, and how this revolution is impacting traditional banks and other incumbents. What changes do we expect technology to bring to the sector going forward, and how must companies adapt?

Need to know

- The financial sector has undergone profound changes because of technology, and the transformation is ongoing. Not everyone will survive
- Digital payment companies are more profitable and have better structural growth dynamics than traditional banks – driven by several key secular trends
- Two big themes in the spotlight for the near future are embedded finance and artificial intelligence



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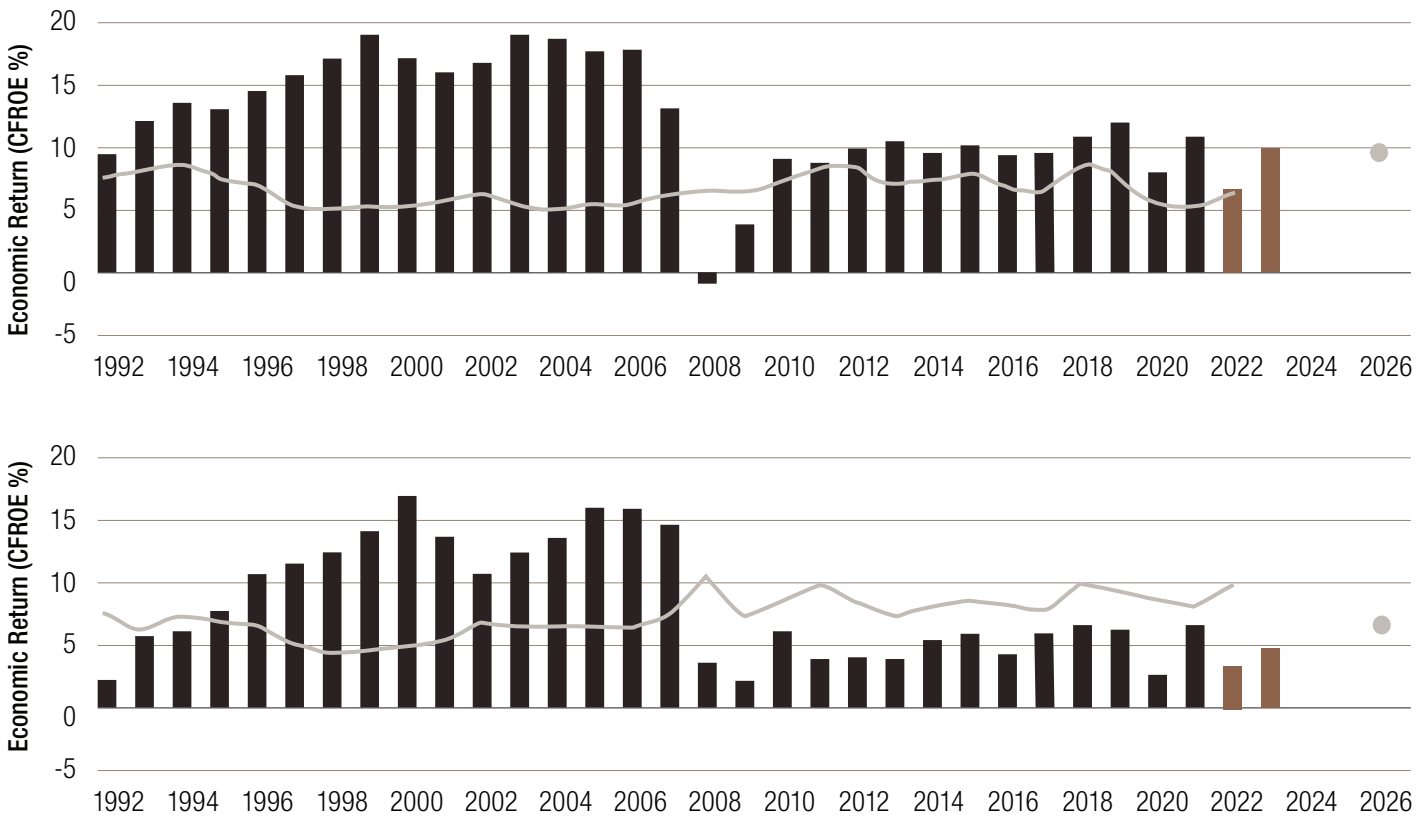
The new financials

With the help of technology, consumers can now perform a range of financial tasks on their smartphones – everything from making payments and transferring money, to applying for mortgages and managing investment portfolios.

The disruption from fintech has been so profound that digital payment companies are now classified as financials – alongside traditional banks, accounting firms and insurance companies. In March, a reshuffle of MSCI's Global Industry Classification Standard (GICS) framework moved fintech companies from the Information Technology sector to a sub-industry in Financials called Transaction & Payment Processing Services.

We predicted that fintech would become the new financials when we launched our Global FinTech strategy three years ago, and MSCI has now made it official. So, what are our new predictions in 2023? As fintech companies continue to infiltrate the world of traditional finance, we see wide-ranging implications – both for portfolios and for the industry.

FIG 1. CASH FLOW RETURN ON EQUITY (CFROE) FOR NORTH AMERICAN AND EUROPEAN BANKS



Source: Credit Suisse HOLT, all companies aggregated on weighted basis using CFROE Banks, Banks for Europe and US-Americas, September 2022.

No value in traditional banking

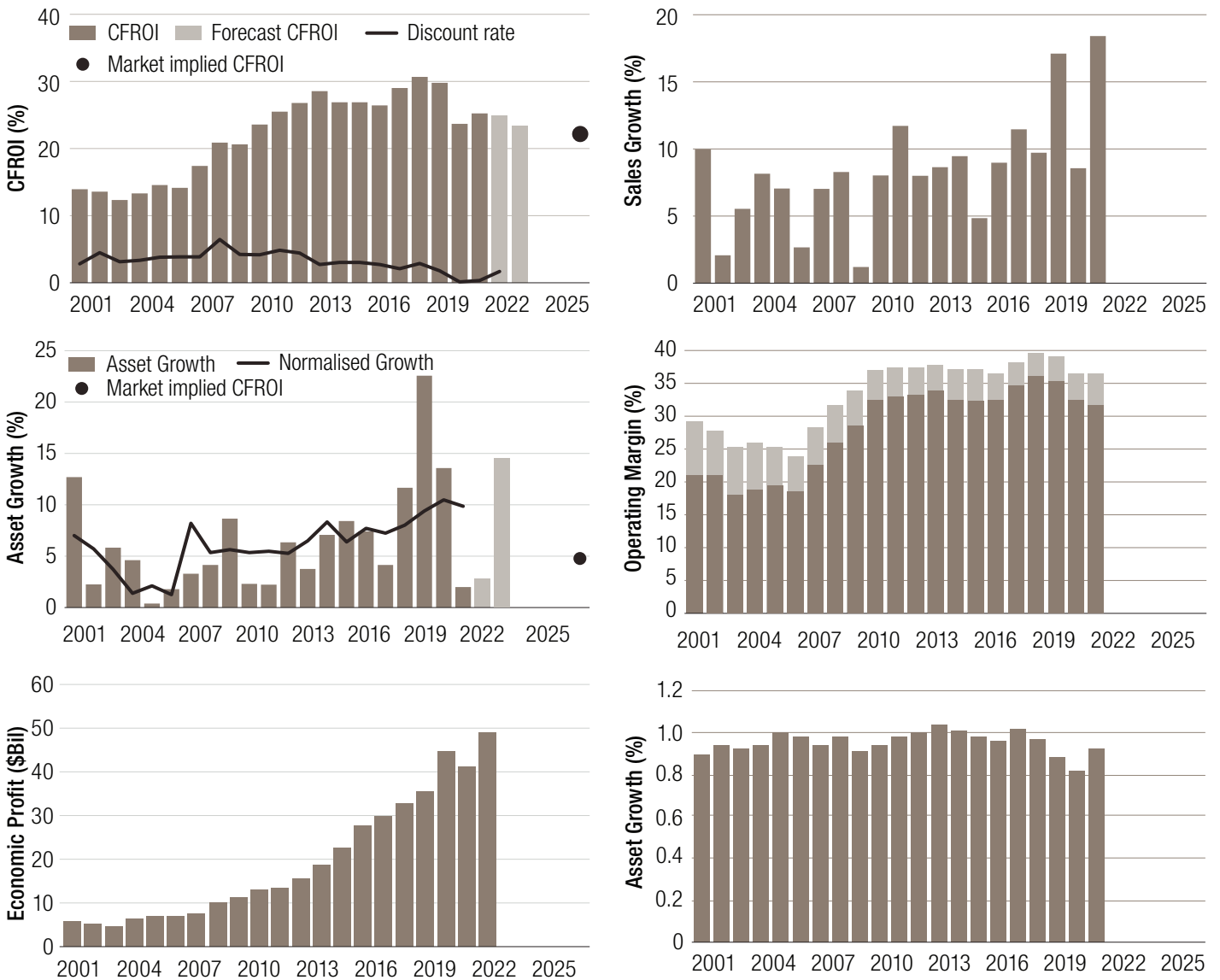
The GICS reshuffle means that digital payment companies no longer have to compete with Big Tech for attention. They compare very well in their new peer group, especially when it comes to profitability.

As figure 1 shows, cash flow return on equity (CFROE) in traditional banking is not spectacular. This is particularly true in Europe, although recent US bank collapses may lead to more parity if possible new regulations pressure margins in the short to medium

term. US banks may also need to increase core tier 1 capital rates, bringing them more in line with European peers. That would mean having less capital available for business expansion.

Looking at CFROE relative to cost of capital also underscores the lack of economic value in traditional banking. On average, CFROEs for European banks are far below their cost of capital of around 10%. This implies that the banks are value destructive. Before the [SVB collapse](#), the average cost of capital for US banks was about 6%, but that is likely to increase with regulatory changes.

FIG 2. FUNDAMENTALS FOR GLOBAL PAYMENT COMPANIES. Past performance is not a guarantee of future results.



Source: Credit Suisse, 2022.

How fintech compares

Figure 2 shows the dynamics for the payment sector on a global basis using a comparable metric, which is cash flow return on investment (CFROI).¹ Average returns are structurally higher than they are for traditional financials. Margins are high and stable, and economic profits are increasing because of operating leverage and decreasing funding costs. If we assume a cost of capital of around 10% (which is high), then there is clear value creation with CFROIs above 20% in the payment sector.

To sum up the discussion so far, payment companies are more profitable and have better structural growth dynamics than traditional peers – driven by secular trends that we discuss further lower down. We expect the role of payment companies in portfolios to grow over time as investors learn to appreciate these characteristics.

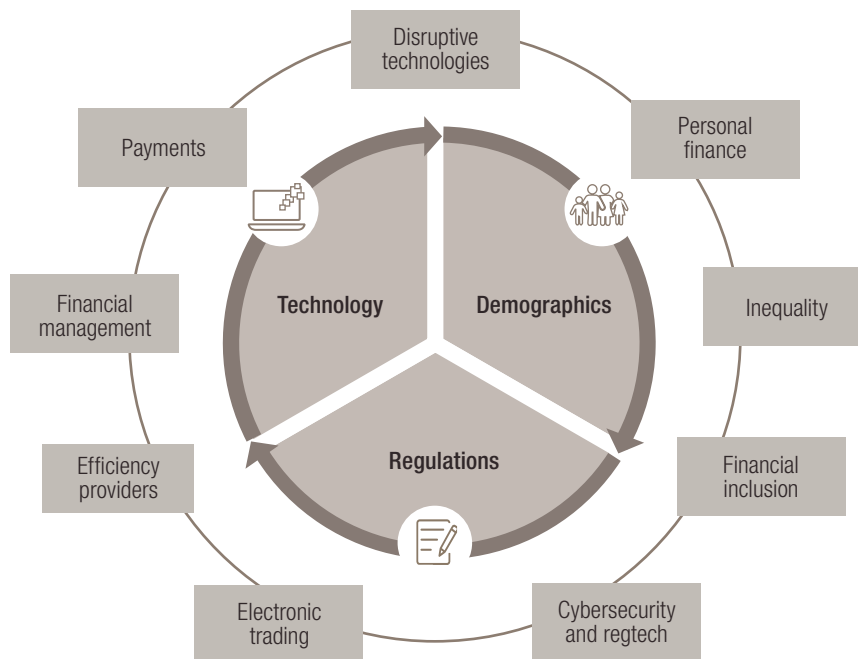
The message for traditional banks, meanwhile, is this: clients are demanding better, faster and cheaper service, and regulators are making increased demands. Any bank that wants to survive going forward will need to have the right technology to protect their margins. Technology is no longer something that is just nice to have; it is now an absolute necessity.

All of which is good news for fintech. Besides payment companies, we also invest in fintech businesses that are helping traditional financial companies modernise. This includes providers of software for core-system replacement at banks or insurance companies, and IT service companies that specialise in financial products.

Companies operating in this segment are mostly of high quality and very profitable, and they help to diversify the portfolio.

¹ Both CFROE and CFROI are indicators of cash return per unit of investment. CFROE is more relevant for banks given that deposits and loans are owned by clients, therefore the investment side cannot be measured.

FIG 3. DRIVERS OF CHANGE AND THE RESULTING FINTECH TREND CATEGORIES



Source: LOIM. For illustrative purposes only.

What lies ahead

Now that we have explained why we prefer fintech to traditional finance, let us explore the changes we see happening over the next three to five years.

Eventually, all trends can be traced back to three drivers: socio-demographics, policies/regulations and technology. For fintech, we summarise these in figure 3.

Sociodemographic changes affecting fintech relate mainly to age. Today's younger customers, accustomed to social media and ecommerce, gravitate more toward using tech-enabled platforms when consuming financial services. Digitisation of financial services will therefore increase with future generations.

Fintech also has potential [to bring more](#) people into the financial-services fold globally, thus providing a valuable social good. Those who fall below certain wealth thresholds often are not served by banks and insurance companies (or asset managers), as they do not bring in enough profit. That changes with digital applications, where the cost to serve clients is reduced drastically.

Many more people will be able to access at least a basic form of financial service, which over time could lead to better decisions and a way out of poverty. This is the case in both developed countries and emerging markets. As we have noted in our past papers on this subject, almost a quarter of US households are unbanked or underbanked.²

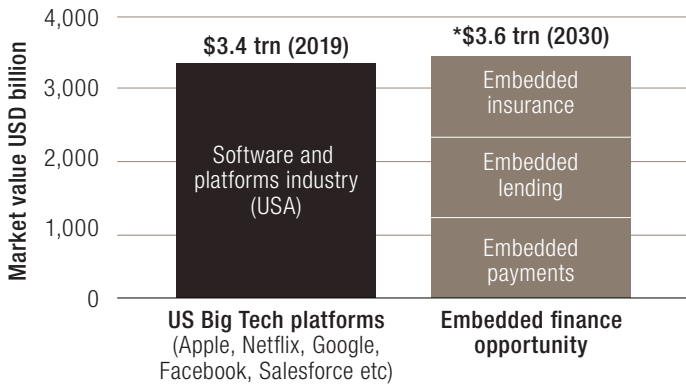
On the regulations front, policies related to new products like 'buy now, pay later' and cryptocurrencies will impact fintech companies and help differentiate winners from losers over the long term. This increases the rationale for investing in quality companies, which have the means and incentive to comply.

Cyber security requirements and data protection are other examples of policy-driven change. We have added cybersecurity screenings to our toolset to try to avoid breaches within our holding companies and enhance the risk-return trade-off.

For more on our cybersecurity risk methodology, read our white paper [here](#).

² Source: Federal Deposit Insurance Corp. (FDIC) 2022 American Banker.

FIG 4. MARKET OPPORTUNITY FOR EMBEDDED FINANCE BY 2030



Source: CX Lab, 2022, based on Bain Capital research for the US market.³

* Based on current adoption trends continuing, and assuming that 40% of payments volume, 20% of lending volume and 20% of insurance volume moves to an embedded finance model by 2030.

Embedded finance, AI

Where the market tends to overestimate change in the short term and underestimate it in the long term is with technology – the so-called Amara’s Law. Technology evolves continuously in fintech.

Digital assets that might become part of our investible universe going forward include blockchain rails for cross-border payments, or central bank digital currencies that will affect payment flows.

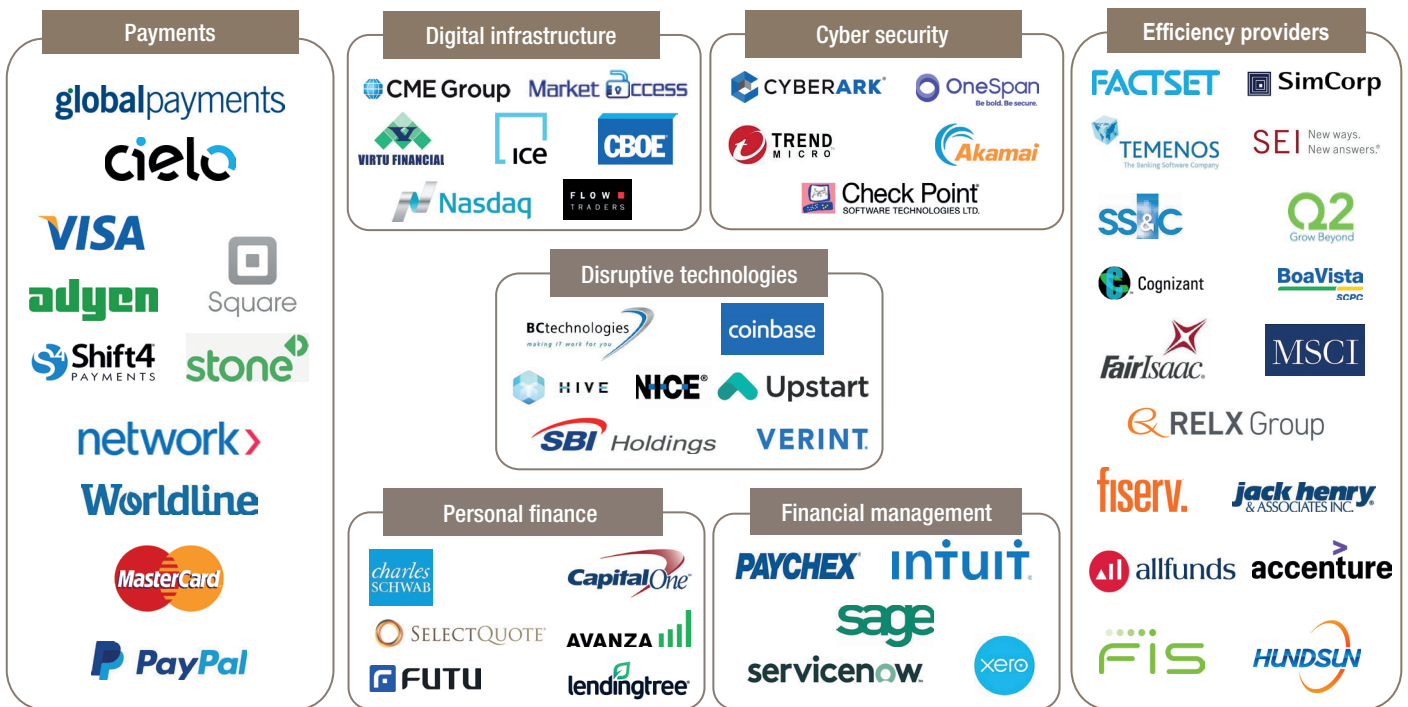
We can point to two main themes for the future of fintech: embedded finance and artificial intelligence.

Embedded finance refers to the integration of financial services with products offered by non-financial businesses – the so-called Banking as a Service (BaaS) model. The non-bank business has the clients and owns the data, but a traditional, licensed financial institution ultimately executes the transaction. Examples include paying for taxi rides via apps or using a phone to pay in shops.

For Big Tech, offering financial services is a way to keep clients on their platforms. Apple is moving aggressively in this area, [in cooperation](#) with Goldman Sachs³. We expect more platforms to follow that lead, while financial incumbents face an increasing [competitive threat](#).

Our portfolio also comprises quality companies that are integrating AI into their service (NICE, Verint, Visa and Mastercard are already doing this³). Within payments, for example, fraud prevention happens via AI. The opportunities from AI are huge and have potential to create even better service offerings.

FIG 5. LOMBARD ODIER FINTECH UNIVERSE SNAPSHOT



Source: LOIM, March 2023.³

³ 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.

All of these trends discussed above result in a pure-play investment universe of more than 300 companies that benefit from the digitalisation of the financial sector. A snapshot of this universe is shown in figure 5. We perform a quality overlay on top of this universe to select the best business models and financial track records.

We have constructed a balanced, high-conviction portfolio of 40-60 companies. The diversification benefits within fintech remain large. A payment company is different from a personal finance company, which differs from an efficiency provider, which again is different from companies operating in the disruptive technologies segment.

Keeping our focus

In conclusion, the financial sector is set for more dramatic change in the coming years as barriers to entry fall. Only the most tech-savvy institutions will survive, in our view. Ultimately, we expect a long trail of traditional financial institutions to gradually disappear.

By comparison, fintech stocks add value to portfolios given their high-quality nature and potential for growth from secular trends including widening financial inclusion.

We intend to keep the same focus we have had since we started our Global FinTech strategy three years ago, with a mantra of quality growth at a reasonable price. This ethos has proven its value versus other fintech strategies focusing on different investment styles.

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